

# Superannuation: Alternative Default Models

Productivity Commission Draft Report

March 2017

This is a draft report prepared for further public consultation and input.
The Commission will finalise its report after these processes have taken place.

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## **The Productivity Commission**

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).

# Opportunity for further comment

You are invited to examine this draft report and comment on it by written submission to the Productivity Commission by **Friday 28 April 2017**. Further information on how to provide a submission is included on the inquiry website at <a href="https://www.pc.gov.au/inquiries/current/superannuation/make-submission">www.pc.gov.au/inquiries/current/superannuation/make-submission</a>

The final report will be prepared after further submissions have been received and public hearings have been held, and will be forwarded to the Australian Government by 17 August 2017.

# Public hearing dates and venues

Location	Date	Venue
Melbourne	3 May 2017	Productivity Commission
		Level 12, 530 Collins Street
Sydney	8 May 2017	The Grace Hotel
		77 York Street

# **Commissioners**

For the purposes of this inquiry and draft report, in accordance with section 40 of the *Productivity Commission Act 1998* the powers of the Productivity Commission have been exercised by:

Peter Harris Chair

Karen Chester Deputy Chair

# Terms of reference

## EFFICIENCY AND COMPETITIVENESS OF THE SUPERANNUATION SYSTEM

I, Scott Morrison, Treasurer, pursuant to Parts 2, 3 and 4 of the Productivity Commission Act 1998, hereby request that the Productivity Commission conduct: a study to develop criteria to assess the efficiency and competitiveness of the superannuation system; and an inquiry to develop alternative models for a formal competitive process for allocating default fund members to products.

# **Background**

An efficient superannuation system is critical to help Australia meet the economic and fiscal challenges of an ageing population. The superannuation system has accumulated over \$2 trillion in assets. Given the system's size and growth, the system is of central importance to funding the economy and delivering retirement incomes.

MySuper has been a strong step in the right direction but more needs to be done to reduce fees and improve after-fee returns for fund members. The Financial System Inquiry noted that fees have not fallen by as much as would be expected given the substantial increase in the scale of the superannuation system, a major reason for this being the absence of consumer-driven competition, particularly in the default fund market.

These Terms of Reference follow from the Government's response to Financial System Inquiry Recommendation 10 on efficiency in superannuation. The Government committed to tasking the Productivity Commission to develop and release criteria to assess the efficiency and competitiveness of the superannuation system, including the choice and default markets and to develop alternative models for allocating default fund members to products.

This work will inform a review of the efficiency and competitiveness of the superannuation system, which the Productivity Commission will be asked to undertake following the full implementation of the MySuper reforms (after 1 July 2017).

# **Process**

The Productivity Commission is to develop criteria to assess the efficiency and competitiveness of the superannuation system and release the criteria within nine months of receiving these Terms of Reference. The release of these criteria is intended to provide

transparency and certainty to the superannuation industry about how it will be assessed ahead of the full implementation of MySuper.

The Productivity Commission is to develop alternative models for a formal competitive process for allocating default fund members to products. In developing alternative models, the Productivity Commission should be informed by the criteria it develops to assess the efficiency and competitiveness of the superannuation system. The Productivity Commission should report on alternative models within 18 months of receiving these Terms of Reference.

For both elements, the Productivity Commission should consult widely and undertake appropriate public consultation processes, including inviting public submissions and conducting industry roundtables. The Productivity Commission is to provide both draft and final reports and the reports will be published.

# Scope of study: development of criteria to assess efficiency of super system

The Productivity Commission should develop criteria to assess whether and the extent to which the superannuation system is efficient and competitive and delivers the best outcomes for members and retirees, including optimising risk-adjusted after fee returns. In determining the criteria to assess the efficiency and competitiveness of the superannuation system, the Productivity Commission may have regard to:

- operational efficiency, where products and services are delivered in a way that minimises costs and maximises value, which can be enhanced by competition and innovation from new entrants and incumbents:
- allocative efficiency, where the system allocates resources to the most productive use and optimally allocates risks;
- dynamic efficiency, including services to members, where the system induces the optimal balance between consumption and saving over time; and
- the extent to which the system encourages optimal behaviour on the part of consumers, including consideration of the learnings from behavioural finance.

The Productivity Commission should consider the nature of competition in the superannuation industry, the effect of government policy and regulation on the competitiveness and efficiency of the system and relevant international experience.

## Scope of inquiry: development of alternative models

The Productivity Commission is to examine alternative models for a formal competitive process for allocating default fund members in the superannuation system to products and to develop a workable model, or models, that could be implemented by Government if a new model for allocating default fund members to products is desirable. These model(s) would provide viable alternatives for the Government's consideration, depending on the

outcomes of the review of the efficiency and competitiveness of the superannuation system, which the Productivity Commission will be asked to undertake following the full implementation of the MySuper reforms.

The developed model(s) should enhance efficiency in the superannuation system in order to improve retirement incomes, including through optimising long-term net returns to members, and build trust and confidence in funds regulated by the Australian Prudential Regulation Authority (APRA). The models developed should consider default fund selection across the superannuation system as a whole.

The Productivity Commission may consider auction, tender and other types of competitive processes. The Productivity Commission should consider the merits of different approaches, the metrics for conducting them and their frequency. This should include consideration of

- the strengths and weaknesses of competitive processes used internationally, such as Chile, New Zealand and Sweden, as well as those used in large corporate tenders by the Northern Territory Government and in other jurisdictions;
- the costs and benefits of different mechanisms, including:
  - optimising long-term after fee returns;
  - the administrative, fiscal, individual and complexity costs;
- and in examining different processes, consider:
  - the robustness of the process, including against gaming and collusion;
  - whether the structure achieves efficient outcomes and facilitates ongoing innovation over the long run;
  - the effect on system stability and market concentration;
  - who should run the process; and
  - the extent to which the process promotes the interests of consumers.
- regulatory impediments to optimal competition under the preferred model(s).

Principles for designing a model for a competitive process should include:

- **Best interests:** ensure incentive compatibility with meeting the best interests of members, encourage long-term investing, and encourage a focus on expected after-fee returns based on asset allocation and investment strategy.
- Competition: drive pressure on funds to be innovative and efficient, diversify asset allocation and optimise long-term after-fee returns by rewarding best performers. Facilitate new superannuation fund entrants to the market.
- **Feasibility:** ensure the process is low-cost and easy to administer and minimises regulatory costs on industry, including business and employers.

- Credibility and transparency: make relevant information public; avoid room for gaming the process; and ensure metrics are clear, simple, difficult to dispute and difficult to manipulate.
- Regular assessment and accountability: regularly conduct a repeat process that requires default funds to earn their right to receive new default members, and ensure funds are accountable for the outcomes they deliver members.
- **Fiscal implications:** the extent to which the process can reduce reliance on the Age Pension and/or give rise to other risks or costs to Government.

The Productivity Commission should draw on expertise in the field of competitive models.

# S. MORRISON Treasurer

[Received 17 February 2016]

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# **Abbreviations**

AFP Administradoras de Fondos de Pensiones (Chile)

APRA Australian Prudential Regulation Authority

ASIC Australian Securities and Investments Commission

ATO Australian Taxation Office

BOOT Better off overall test
CPI Consumer price index

FSI Financial System Inquiry
FWC Fair Work Commission

NEST National Employment Savings Trust (United Kingdom)

PC Productivity Commission

RSE Registrable superannuation entity

SG Superannuation Guarantee

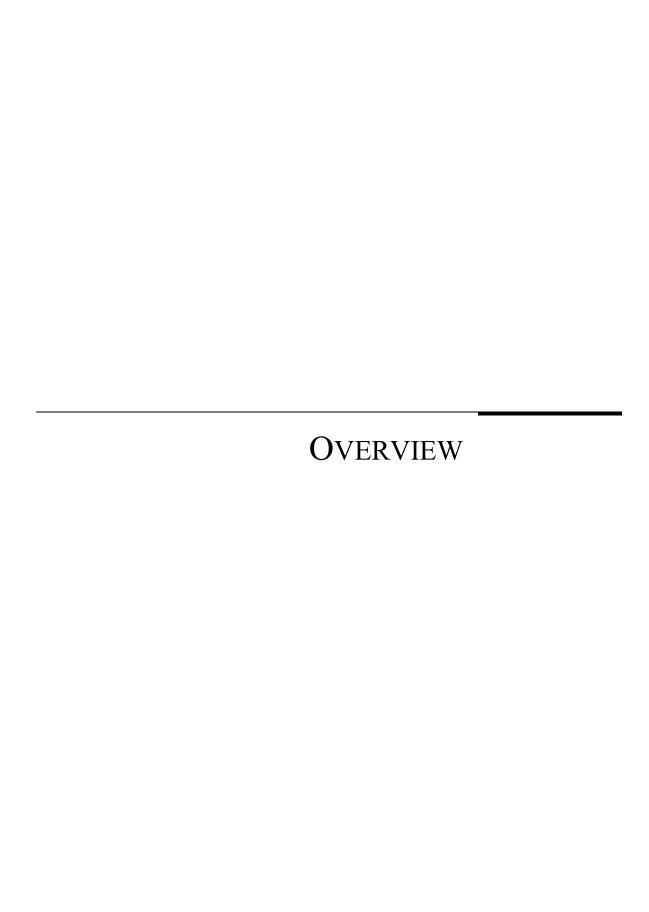
SG Act Superannuation Guarantee (Administration) Act 1992 (Cwlth)

SIS Act Superannuation Industry (Supervision) Act 1993 (Cwlth)

SMSF Self-managed superannuation fund

SPA Swedish Pensions Authority

TPD Total and permanent disability



# **Key points**

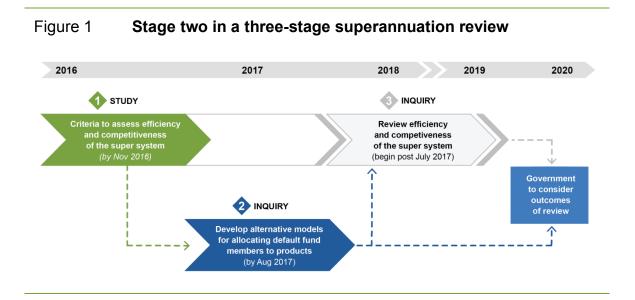
- Superannuation has evolved much since compulsory superannuation was first introduced a
  quarter of a century ago. Today's default arrangements evolved historically within the
  workplace relations system, and provide a safety net for employees that don't or cannot
  make a decision in a world of compulsion.
- So after 25 years, this Inquiry is a timely opportunity to look at potential ways to introduce more competition into a system that benefits from a large flow of mandated superannuation contributions, and much of that from disengaged members.
- Complementary policy action (including to extend genuine member choice to all employees)
  is needed to deliver the full potential benefits of member-driven competition under the
  models we identify and even under current default arrangements. The freedom to make
  choices is necessary to realise the benefits of competition.
- Two-thirds of members stick with their default fund. If the system is going to rely on defaults, it needs to guide members to products that at a minimum seek to maximise long-term net returns.
- In this draft report the Commission has developed four alternative models that are likely to outperform a baseline of 'no defaults' on member benefits and competition.
  - They try to address the core problem in superannuation the sheer complexity of decision making coupled with compulsion — by increasing the availability and quality of information or nudging choice to a smaller set of high-quality products.
  - But these interventions come at a cost, and each model has different relative strengths and weaknesses.
- Members who do not exercise choice should be allocated to a default product only once.
   The current system's propensity to create multiple accounts is an egregious systemic failure.
   It warrants more than the incremental remediation to date.
  - This approach would result in a smaller pool of employees being defaulted each year, but it should be sufficient to generate competitive dynamics.
- There should be a government-run centralised online information service, with universal participation by employees and employers, to facilitate more efficient allocation of default members to products.
- A centralised clearing house (akin to New Zealand's), while a more ambitious undertaking, would have wider and more enduring member benefits.
- Member outcomes would also benefit from more transparent disclosure by funds regarding merger considerations, to hasten the exit of underperforming funds.
- Certain reforms indicated in this report will be examined further in the stage 3 review.

# Overview

In Australia's superannuation system, most risks — in relation to the level of contributions, investment returns, fees and ultimately the benefit in retirement — lie with the individual. And yet the superannuation system hasn't always afforded or encouraged individual decision making. Some is well-intentioned paternalism, reflecting the compulsory and complex nature of superannuation, while other arrangements are merely a historical overhang. Both elements coexist in Australia's arrangements for allocating default superannuation members to products ('default arrangements').

In many ways default arrangements can be beneficial to members and are common around the world in retirement savings systems. But they can also stifle competition and innovation that would otherwise occur when consumers make active decisions, and discourage individuals learning about a sizeable asset held on their behalf. Striking the right balance between these benefits is imperative for a system that collectively compels large mandated savings and affords individual responsibility (and with it risk), and an economy where job mobility is the norm.

The Commission has been asked to develop alternative workable models for a formal competitive process to allocate default superannuation members to products. These new alternative models could be implemented by the Australian Government if deemed desirable following the Commission's future review of the efficiency and competitiveness of the superannuation system — to be undertaken sometime after 1 July 2017.



This Inquiry represents the second of three related pieces of work on superannuation to be undertaken by the Productivity Commission (figure 1). These stem from the Australian Government's response to the recommendations of the 2014 Financial System Inquiry (FSI). The FSI found that the superannuation system was not operationally efficient due to a lack of price-based competition in the superannuation default market.

Importantly, the Commission's task in this Inquiry (stage 2) is to develop *new competitive models* for future consideration by the Australian Government. The Commission is not tasked in this Inquiry to form a view on whether alternative models are better or worse than the current default arrangements, nor on the merits of the current default arrangements. This is core to the overall competitiveness and efficiency of the superannuation system and will therefore be examined as part of the stage 3 review of the competitiveness and efficiency of the superannuation system.

# The role of competition in superannuation

Competition can promote better outcomes for consumers, such as lower prices, improved service quality and product innovation. There are several reasons why these competitive ideals may not be realised in the superannuation market.

First and foremost, superannuation in Australia is based on compulsion, which can limit the demand-side pressure exerted by members. Member passivity and disengagement are further compounded by the complexity of retirement saving decisions, long time horizons, various behavioural and cognitive biases, and the costs of active involvement. At their core, these are **information problems** — incomplete information or asymmetric information — exacerbated by cognitive constraints.

The absence of strong member engagement can dull competitive pressure on superannuation funds, regardless of the presence of many funds in the market. Moreover, the information problems can create a risk of unhealthy and wasteful competition, such as excessive advertising and product proliferation.

Policy intervention can potentially improve on these outcomes by helping members make better choices, or via default selection processes reducing risk as members opt out of choice. Policymakers can also intervene on the supply side to steer competition and trustee behaviour to more beneficial aspects.

# Default arrangements in Australia

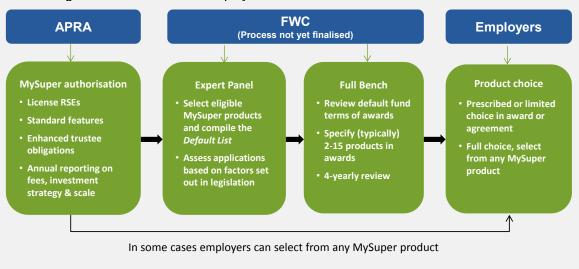
Defaults have been integral to the development of Australia's superannuation system, largely stemming from the decision to make superannuation compulsory and the inherent complexity for individuals in making decisions about retirement saving. Defaults also potentially reduce the cost and complexity for employers of complying with their

Superannuation Guarantee (SG) obligations. Most private pension systems around the world rely on defaults to some extent.

# Box 1 Current default arrangements

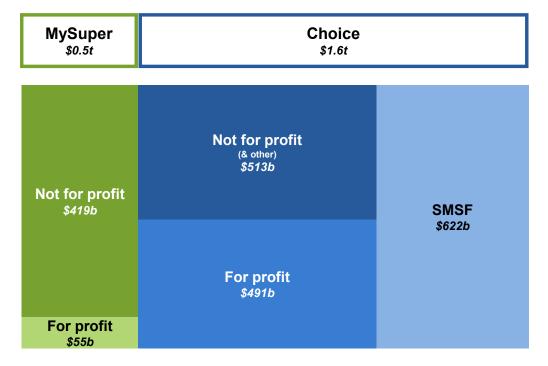
Under the *Superannuation Guarantee* (Administration) Act 1992 (Cwlth), employers are required to make contributions to their employee's superannuation fund (with limited exemptions). Most employees have the opportunity to choose which fund these contributions are paid into. However, for those employees that do not make an active choice, employers are required to nominate a fund — which is thus the default fund. The rules surrounding this process vary significantly across industrial awards, agreements, contracts and other employment arrangements. Once a default fund has been selected, fund trustees are required to place default contributions into that fund's default product, which in most cases must be a MySuper product.

These arrangements are the result of historical workplace arrangements and the introduction of MySuper products as part of the Stronger Super reforms in 2013. In summary, there are up to four 'third parties' involved in the selection of default products for members that fail to make an active choice — the regulator (APRA), an expert panel within the Fair Work Commission (FWC), the full bench of the FWC and, finally, employers. These third parties have differing objectives and accountabilities. Employers in particular report disparate appetite and capability in selecting default funds for their employees.



The issue of default arrangements is highly contentious and politically sensitive. While defaults (MySuper products) only make up about a quarter of total superannuation assets (figure 2), they are more significant in terms of their share of members (putting a number on this is difficult due to systemic data gaps). Survey evidence suggests about two thirds of superannuation fund members stick with their default fund (and fewer than 5 per cent of members switch once they are in a fund). Opening up access to these members and their contributions is a lucrative proposition for new entrants and a competitive threat for incumbents (especially the relative poor performers).

Figure 2 Size of the superannuation market, June 2016



Other includes 'balance of life office statutory funds' and small APRA funds.

Some inquiry participants argued that the current default arrangements have served members well by placing them in funds with a culture of serving others and operating in the best interests of members, not shareholders or other related parties. In support of this view, many of these same participants highlighted empirical evidence of superior returns in not-for-profit funds relative to for-profit funds, and for default funds named in modern awards in particular. And while this is historically true *on average*, it does not hold for all industry funds.

Other participants, including retail funds, suggested that supply-side barriers (particularly in industrial awards and agreements) ultimately constrain competition and innovation which could benefit members. Moreover, they highlighted that even within the population of current 'no frills' MySuper products there is significant diversity in investment performance.

But it is unwise, as many have to date, to portray this Inquiry as just another 'industry fund versus retail fund' debate. This Inquiry is much more than that — it is a wake-up call to the entire industry, which some claim has become complacent with a steady flow of mandated contributions from disengaged members, and as an industry has failed to improve its scale and efficiency and deliver better outcomes for members (despite the MySuper reforms).

From this perspective, the Inquiry has managed to unite the superannuation industry against the Inquiry's potential contemplation of more-than-incremental reform. A healthy

dose of scepticism would suggest that there must be rents to be recovered for the benefit of members for such unanimity to be valid.

Most participants from the superannuation industry argued that some form of default arrangements is needed for the foreseeable future (if not into perpetuity). Many participants voiced a familiar objection to the view that competition could promote member interests, instead placing faith in the goodwill and legal obligations of trustees. This Inquiry will test that proposition more fully.

# How we developed the alternative models

Competition that merely sought to increase the already daunting number of choices (more than 110 MySuper products alone) would almost certainly do nothing to assist the potentially disengaged member, default or otherwise. Such is not, however, the paradigm for this Inquiry. The aim, as set by the Terms of Reference, is to determine if and how competition might make choice simpler or to lower the risk of not exercising choice.

There are various ways that a competition lens can inform the design of alternative models for allocating default members. Broadly, competition can be promoted in one of two ways:

- competition *in* the market competition based on conventional demand- and supply-side interactions between employees (members) and trustees (funds)
- competition *for* the market competition between funds via some form of formal process to earn the right to gain access to default members.

Promoting competition *in* the market needs consumers to make choices. While most employees already have the opportunity to choose which superannuation product their contributions are paid into, some employees are restricted from doing so (previously estimated to be in the order of 20 per cent of members). Freedom to make choices — which includes the freedom to make mistakes — is a necessary condition to realise the benefits of competition *in* the superannuation market. It is therefore essential to extend genuine member choice to all employees.

Promoting competition *for* the market may be desirable where it is not feasible to promote effective competition in the market, such as where member engagement is low or there are barriers to entry and exit. Typical ways to promote competition for a market include a tender or auction process.

The Commission has taken a broad interpretation of what constitutes a formal competitive process for the default market. It is any *new alternative* model that permits open participation, encourages rivalry between funds to the benefit of members, and involves products being selected for members based on merit.

There are three key steps to developing alternative competitive models:

- 1. specifying the market (*members* and *products*) to which the model applies
- 2. determining the type of selection mechanism for default products
- 3. determining the decision-making process for allocating members to those products.

The first step — what is the default market — is consistent across models and is discussed further below. The four models presented in this draft report differ on the second and third steps. The product selection mechanisms (step 2) are either administrative (such as a product filter based on certain standards) or market based (such as an auction). The distinction between administrative and market mechanisms is not necessarily stark: a 'heavier' filter, which includes relative performance standards, is very similar to a multi-criteria tender. The choice of the selection mechanism ultimately depends on the degree of filtering and who will be allocating members to products (step 3). The Commission has chosen the combinations that work well together.

Some models have not been considered in this Inquiry because they are not consistent with the competitive focus in the Terms of Reference — for example, a single sovereign fund that receives default contributions by fiat.

## What is the market at stake?

# The default member

Currently, an employee typically acquires a new default superannuation account every time they commence a new job and do not actively choose a fund themselves (the **turnover pool**). This creates a significant proliferation of accounts, with over 40 per cent of members holding more than one account.

This Inquiry is taking an alternative approach as suggested by the FSI in 2014: employees who fail to exercise choice <sup>1</sup> will be allocated to a default product only if they do not have an existing superannuation account. These would typically be new entrants to the workforce (the **first-timer pool**), and they will retain that account (including through a change in employer) unless they actively switch. Other employees who commence a new job would see their SG contributions flow to one of their existing superannuation accounts, or a new account of their choice.

There would be about 400 000 new default members each year under the Commission's first-timer definition, with about \$800 million in annual contributions. This is evidently much lower than the contributions in the turnover pool. This pool, while being hard to

None of the models presented in this report mandate that employees join or remain with a particular default product. Employees would have the right to choose their own fund and product, and to switch funds or products after joining.

estimate because of systemic data gaps, would have more members (in the short term) and higher average incomes.

Nonetheless, the first-timer pool is not insignificant, particularly in the medium term. A key reason for its initial modest size is that the average income of first-timer members is about \$21 000 (which reflects the part-time or casual nature of many first jobs). Contributions from each year's cohort would grow at a faster rate than for people in the turnover pool as they converge towards average incomes; applying average incomes to this cohort yields a pool of just over \$2 billion. These younger members would likely remain in their original product for a longer period, and thereby offer successful funds the benefits of improved inflow—outflow ratios and thereby readier liquidity management.

In this draft report, the Commission is keen for participant feedback on the proposal to restrict the default models to people who do not already have a superannuation account, and what this implies for the competitive dynamics of any alternative model. For example, which funds would not compete for this default pool, and why not? The impact on funds heavily dependent on constant inflows of default members might at first glance appear self-evident but in the Commission's thinking this might be wrong. The presence or absence of complementary reforms to barriers affecting choice appears likely to make some difference.

The key benefit of restricting the new default allocation models to the first-timer pool is the immediate 'circuit breaker' of reducing wasteful account proliferation, which erodes member balances via multiple sets of fees and insurance policies. The FSI found that addressing account proliferation and lost accounts could increase superannuation balances at retirement by around \$25 000. Multiple accounts are especially problematic among younger members, for whom it is less likely to be a deliberate outcome. This erosion is further exacerbated where young members have inappropriate insurance policies with their superannuation funds. Overall, account proliferation is one of the superannuation system's worst systemic failings and warrants more than the incremental remediation to date.

This approach is contingent on universal use of a centralised online information service to enable employers to identify which employees do not already have an existing account and to facilitate members to consolidate their accounts. At a system level, this service will generate information about employee decisions that will fill important evidence and data gaps for future policy decisions. The ATO is currently developing platforms that might be adaptable to the task.

A centralised clearing house<sup>2</sup> would bring additional member (and efficiency) benefits to the superannuation system, as evident in New Zealand with the role played by the Inland Revenue Department. These benefits include administrative simplicity for employers and funds, which makes it more attractive to new entrants, and easier oversight of employer

Whereby employers would remit all superannuation contributions directly to the clearing house, with the clearing house then transferring those contributions to the relevant superannuation funds.

compliance with SG contributions. A clearing house will be explored further in the stage 3 review.

# Implications for existing default members

While this Inquiry's focus is on how to allocate *new* default members, any new allocation process poses the question of how to treat the large stock of *existing* default members. How these existing members are treated has implications for competitive dynamics, as well as broader system efficiency and fairness.

A fund whose product 'wins' default status for contributions of *new* default members would have to extend the same fees and service terms to its *existing* members in the default product. This would be simple and fair — it would avoid a situation where funds have multiple tiers of default members, each in a different product or fee structure — and was broadly supported by inquiry participants. It would also spread the benefits of competition to a wider cohort of default members. But the models in this report do not envisage moving the *entire system's* pre-existing default members to the new default product. This avoids material upheaval, with the potential for near-term instability, in the superannuation system.

# The default product

The bundle of superannuation services (the default product) to which default members would be allocated is also common to all models, and pertains to the accumulation stage only. The default product should be simple, providing the minimum services necessary to meet the Government's stated objective for superannuation — to provide income in retirement to substitute or supplement the Age Pension.

These would include investment, administration of member accounts and intrafund advice. The administrative services and intrafund advice should help members understand the superannuation system and be informed about the performance of their investment product, the fees they are paying, the intrafund switching options and the process for exiting the fund. Importantly, the quality or range of ancillary services per se should not be the main driving factor in selecting default products under any of the allocation models. Funds should primarily compete on long-term net returns and fees for a threshold level of service.

The alternative models will be evaluated on the quality of their default *superannuation* product only — and not on insurance, which is currently bundled with default superannuation on an opt-out basis. In this environment, insurance is best dealt with as a regulatory add-on. The Commission will assume that the trustee chooses to bundle the default superannuation product with insurance, subject to meeting their fiduciary and legislative obligations, but the models do not involve comparing the quality or price of bundled insurance.

The Commission has noted the various tensions of bundling insurance with superannuation in its stage 1 report, and it should also be self-evident to trustees that the Government's stated objective for the superannuation system does not envisage insurance as an essential element of the system.

# The assessment framework

Each model in this draft report has been assessed against five criteria and the assessment is mostly qualitative, given the developmental nature of this Inquiry. The assessment framework was informed by the Terms of Reference and the Commission's overarching objective to promote the wellbeing of the Australian community as a whole.

- **Member benefits:** Does the model create incentives for funds to maximise long-term net returns and allocate members to products that meet their needs?
- Competition: Does the model encourage open participation (contestability) and rivalry between funds (competition) to drive innovation, cost reductions and more efficient long-term outcomes for members?
- **Integrity**: Does the model promote a high-degree of integrity in the selection and delivery of default superannuation products, and the ongoing behaviour of superannuation funds more broadly?
- **Stability**: Is the model likely to create instability in the superannuation system that leads to significant systemic risks?
- **System-wide costs**: Does the model minimise overall system-wide costs, taking into account costs on members, employers, funds and governments?

There was broad agreement among inquiry participants that members' best interests should be paramount in the assessment. In many (if not most) cases, a model that promotes members' best interests could also be expected to promote the wellbeing of the Australian community.

The assessment of alternative models requires a common reference point or **baseline** for comparison. The Commission is using the baseline of no default arrangements. This proposal elicited a substantial amount of participant feedback, which fell into two broad categories: participants who wanted the models compared to current default arrangements, and participants who interpreted the no-defaults baseline as an alternative model. Neither interpretation is correct.

The no-defaults baseline is not an alternative model in its own right. Rather, the Commission considers this to be as close as is possible to an objective starting point from which to identify the problems that occur in a no-defaults world (the raison d'être of a default system is to address these).

It is also the baseline that can best expose the *relative* abilities of alternative models to address the problems of the default cohort today, rather than past problems and perception, some of which may no longer be relevant. The alternative models need to beat the baseline against the assessment criteria to be considered viable, then prove workable.

# What does the baseline look like?

The baseline is a world of **unassisted active choice**. In the baseline, employers must make SG contributions on behalf of employees. Superannuation funds and products would be subject to prudential, competition and consumer laws and regulations. Employees would be required to choose a superannuation product to receive their contributions. There would be unrestricted choice, but with regulations — employees can choose from any publicly offered *legally complying* superannuation product available in the market (including a self-managed fund).

Employees would be responsible for researching and evaluating available products themselves, albeit with the potential to seek support from third parties of their own initiative — such as employers, unions, financial advisers and ratings agencies. Employers, unions and other intermediaries would also be free to bargain with superannuation funds on behalf of employees to secure group discounts. This would mimic the current practice offered by corporate funds or industry funds, the only difference being that employees would need to actively choose that fund.

# ... And how does it perform against the assessment criteria?

Some employees would struggle to make good long-term decisions in this unassisted active choice world. In particular, they may choose products with high fees or poor investment performance, or pay for additional services (such as a plethora of investment options) they may not need. Further, some employees may choose overly conservative products, reducing their potential retirement income. Importantly, and unlike poor consumer choices in other markets, these costs extend beyond the employee to also be borne by future taxpayers, to the extent that they result in higher Age Pension reliance.

In contrast, a significant benefit of the baseline — which is less evident under default arrangements — is that requiring employees to interact with their superannuation and make an active choice can potentially drive member engagement and ultimately exert competitive forces.

The baseline is considered the purest form of competition, albeit operating in a highly regulated market. The supply side of the market is likely to be highly contestable, with low barriers to entry and exit, and low levels of market concentration. Rivalry between funds is expected to drive innovation over time. However, there is also scope for unhealthy and wasteful competition in the form of superfluous product differentiation and inducements, and excessive advertising.

An unassisted active choice world minimises the number of principal—agent relationships that can lead members astray. That said, potential for conflicts of interest still exists in an unassisted active choice world, primarily where members seek advice from other parties.

The baseline is unlikely to have a destabilising effect on the superannuation system. There would be no reason to expect sudden large-scale changes in the flow of members or assets between funds, or excessive market concentration.

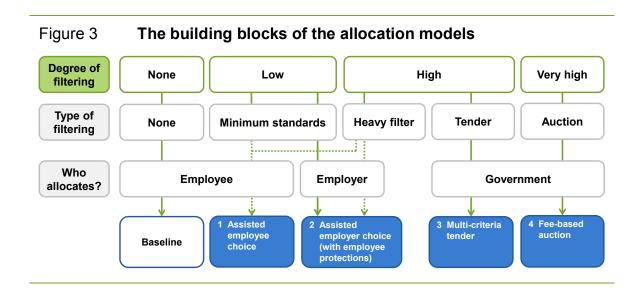
In an unassisted active choice world, members bear most of the costs of allocating themselves to a relevant superannuation product (largely search costs, though some are likely to put in more time and effort than others). While this may not be significant at the individual level, it may be cumulatively significant across the entire system. Costs for other system participants (for example, employers) are expected to be low.

The Commission is undertaking an experimental survey of superannuation decision making which will further add to this evidence base. The results and analysis will be made publicly available (upon completion) and will also be incorporated in the Commission's final report.

# The alternative models in brief

As noted earlier, information problems are at the core of the market failures in superannuation. There are only two pathways to address information problems: increase the availability and quality of information (at a cost) or limit choice to a smaller set of better products. The Commission has developed four new alternative models that do this in some way (figure 3). The key features of each model are noted briefly below, and additional detail about each of the models can be found in their corresponding chapters.

- **Assisted employee choice** this model leverages the competition benefits that arise when members exercise choice, but with information and nudges to assist members to make informed choices.
- Assisted employer choice (with employee protections) this model injects competition by giving employers choice in selecting a default product for their employees, as long as the default product meets some minimum standards, while also simplifying choices for small and medium sized businesses.
- A fee-based auction and a multi-criteria tender these models incorporate a market-based mechanism into the selection of default products, with sequential allocation of members among winning products.



# Model 1: Assisted employee choice

In this model, employees are required to choose a superannuation product themselves (active choice), but are assisted in doing so by a set of policy interventions.

- The primary feature is a non-mandatory **shortlist** of carefully selected products that are deemed to be 'good'. It would nudge employees towards good products without going as far as to impose one by default. The shortlist would consist of between 4 to 10 products, selected by a government body using a heavy administrative filter (see model 2). The shortlist would be accompanied by simple information on key features of each product in a consistent and comparable format.
- A system of product accreditation would encourage funds to provide products which
  have a common, simple design that allows for easy comparisons across different
  products, and thereby makes it easier for employees to choose a product that meets
  their needs. Product accreditation would be voluntary for funds and be akin to a
  strengthened MySuper authorisation process (with a stronger emphasis on minimum
  performance standards). Products would have to be accredited to be considered for
  shortlisting.
- A simple, low-cost last-resort fund (run by existing eligible rollover funds or possibly
  the Future Fund) would hold contributions from employees who fail to exercise choice
  and encourage them to choose their own product.

# Model 2: Assisted employer choice (with employee protections)

In this model, employers choose a default product for their employees who do not exercise choice. In doing so, employers *must* select a product from one of two lists. The model recognises that some (mainly larger) employers are well placed to choose a default product

and negotiate favourable arrangements for their employees, while many (mainly small and medium size) employers are not well placed to select a default product.

- Employers must choose a product that meets mandatory minimum standards: a **light filter**. Mandatory minimum standards are important to protect member interests, given the principal—agent issues inherent in the employer choice environment. The light filter would be akin to a strengthened MySuper authorisation process (with a stronger emphasis on minimum performance standards).
- A heavy filter would apply stricter criteria around investment performance and other product features (similar to the tender criteria below) to identify a narrower 'preferred default' list of the best performing products. The preferred default list would be voluntary for employers, and is designed to assist employers who are not well placed to select appropriate default products for their employees.

## Model 3: Multi-criteria tender

In this model, participants compete for rights to a share of the default pool by making proposals against a number of different assessment criteria, which are weighted by their relative importance. A well designed multi-criteria tender could therefore engender a product that performs well on multiple characteristics that meet members' needs. The key features of this model are:

- a **pre-qualification stage** to ensure participating funds meet minimum criteria relating to governance and transparency
- the **tendering stage**, where participants submit tenders against the following criteria:
  - past performance on net returns and member satisfaction
  - investment strategy
  - the quality of member services, engagement and intrafund advice
  - fee levels and transparency
  - innovation in unspecified areas
- a comparative evaluation stage tenders are evaluated against the criteria and assigned an index score, with up to 10 of the overall best performers being deemed as winners of the tender. A best-and-final-offer stage could be used to encourage convergence where proposals are close, in the interest of members having near equivalence in standards despite being sequentially allocated to a product
- a **performance monitoring and enforcement stage**, with winning providers self-reporting against the commitments made in their winning offers, and a credible threat of losing default provider status in the absence of immediate remediation of a contractual breach.

# Box 2 Who would run the selection process?

All of the models require a selecting body. Because of the competitive assessment nature of the exercise, this body should not be a regulator like APRA or ASIC. The selecting body (or panel) would be established specifically for the selection task each round, and then cease operations — it would have no ongoing role. The selecting body would be overseen by and accountable to the Australian Government. While this places some of the responsibility for the outcomes on the government and so may increase perceived moral responsibility by the government for later poor performance, this is necessary to ensure the integrity and credibility of the process. Government administration of the process should not preclude private-sector participation in an advisory sense.

There are a number of key principles that are relevant to the composition and conduct of this selection body:

- · an obligation to act in the best interests of fund members
- · an understanding of the needs of default members and how these are best met
- · sufficient expertise and knowledge of superannuation and finance
- transparent processes
- procedural fairness (that is, enabling all relevant parties to participate equally)
- · being dispassionate and free of conflicts of interest
- being accountable for its decisions and having credibility with members and funds.

The product selection process should be repeated every four years in the early stages of the operation of the allocation model. The frequency can be reduced in the future.

#### Model 4: Fee-based auction

This model has products competing for default status by out-bidding each other on member fees. A fee-based auction is worthy of consideration for two reasons. First, there is evidence that variation in member fees explains a significant amount of variation in net returns. Second, realising economies of scale would allow the superannuation system to achieve lower member fees without diluting net returns. While both points may be contested, they are not without merit.

- A **pre-qualification stage** is used to ensure participants meet certain minimum standards. Fund-level minimum standards relate to the fund's integrity and capacity to handle expected member inflows. Product-level standards relate to a certain level of member and investment services.
- The auction's **bidding metric** is a composite fee that accounts for administration and investment fees, as these make up the bulk of member charges. The **bidding format** is a first-price sealed-bid.
- The auction would be able to produce **multiple winners** (but also a single winner). The advantage of multiple winners is the wider spread of the lowered fee across the market (noting the requirement cited earlier that winning funds must extend the new fee to

their existing members of the default product). This would be done through a carefully managed best-and-final-offer mechanism, whereby a select number of losing funds may have an opportunity to match the fee and service offering of the winner.

Post-auction monitoring and enforcement mechanisms will be needed to keep the
winning fund(s) to the commitments made in the auction process, including a credible
threat of losing default provider status in the absence of immediate remediation of a
contractual breach.

# Assessing and comparing the models

This section compares how the four alternative models compare to the baseline of unassisted active choice. Unsurprisingly, all of the alternative models outperform the baseline on **member benefits**, because they guide more members to better performing products.

- Models that involve a multi-criteria tender or heavy filter perform relatively better, as their multifaceted selection framework will more comprehensively reflect member needs.
- There is a risk under the fee-based auction that winning funds will eschew higher-cost
  illiquid assets, which have been credited with providing superior diversification and net
  returns in the past to some funds. Nonetheless, putting young disengaged members into
  a low-cost passive fund may be a reasonable choice, which many overseas default
  models apply (albeit with many combining passive with conservative investment
  strategies).
- The models with defaults could deter some employees (with moderate levels of engagement and literacy) from actively researching products themselves. The higher level of member engagement in the baseline is better maintained in the assisted employee choice model.

All of the models also outperform the baseline on **competition**, because they focus competition on aspects of member value.

- The models that centralise allocation decisions in the hands of government (auction, tender and heavy filter) have high levels of filtering and therefore focus competition *for* the market on the factors that matter for members, at least in the short to medium term.
- The models with employee or employer choice have high competition *in* the market (due to a large number of both buyers and sellers). Any models that have high competition *in* the market will invariably have high marketing costs and some scope for unhealthy and wasteful competition (but less than the baseline). But this type of competition is healthier in the long term, because it is better able to innovate and anticipate shifts in consumer needs.

All of the models bring new parties into the decision-making process compared to the baseline, some more so than others. This will unavoidably introduce conflicts of interests undermining **integrity**.

- The auction, tender and heavy filter models put a significant onus on government to get the selection right. This invariably heightens the risk of getting it wrong a lot rests on the integrity of the selection body and process. There is a risk that the selection process will be too conservative, or try to be all things to all people. And this is apparent from international experience.
  - These risks are probably smallest for the fee-based auction because of its relative simplicity. The complexity of weighing multiple criteria may create a perception (or reality) that the preferred list panel moves to a lowest common denominator and fails to objectively and robustly evaluate products.
- Additional integrity concerns arise in models with employer choice, particularly given the implausibility of imposing a regulatory obligation upon employers to act in their employees' best interests.
- But the models can also promote integrity by reducing scope for exploitative behaviour
  that can occur in the presence of compulsion and complexity. The additional consumer
  protections and the selection processes can build trust and confidence in funds and the
  system. Moreover, the accountability and transparency mechanisms embedded in each
  model are likely to be more effective in holding funds to account than unassisted active
  choice.

No model is expected to introduce excessive levels of market concentration or unmanageable risks to the **stability** of the system.

**System-wide costs** under all of the models are either similar or slightly lower than the baseline — a simple function of the smaller decision making cohort. All of the models reduce search costs for members and, because the set of choices is narrowed under all models, there are likely to be reductions in system-wide marketing costs. This will be offset to some extent by additional costs associated with selection processes and consumer protections.

- The models with mandatory minimum standards or product accreditation (assisted employer choice (with employee protections) and assisted employee choice) have relatively higher costs because these models require ongoing regulatory oversight of a potentially large number of products.
- System-wide costs are likely to be lower for the auction and tender. The cost of a quadrennial selection exercise is likely to be small, and would require self-reporting and monitoring of only a small number of products.

# Draft findings and recommendations

#### **DRAFT FINDING 1.1**

Complementary policy action (including to extend genuine member choice to all employees) will be needed to deliver the full potential of member-driven competition under the alternative models developed in this Inquiry and also under current default arrangements.

#### **DRAFT FINDING 1.2**

Where there is third-party involvement in the selection of a default product, there needs to be effective regulation or arrangements in place to ensure these third parties act in the best interests of members.

#### **DRAFT FINDING 1.3**

For the purposes of this Inquiry, a formal competitive process for allocating default members constitutes any new alternative process that permits open participation (contestability), encourages rivalry between funds (competition) to the benefit of members, and involves products being selected for members based on merit.

# DRAFT FINDING 3.1

The current arrangements where members can be defaulted to a new account on every change of job increases the proliferation of accounts. This materially adds to costs for members and reduces member balances at retirement.

#### **DRAFT RECOMMENDATION 3.1**

To avoid perpetuating the legacy problems of the current system, any future alternative system for allocating members to default products should be premised on employees being assigned a default product only once, when they join the workforce.

#### **DRAFT RECOMMENDATION 3.2**

The Australian Government should establish a centralised online service for members, employers and the Government that builds on existing functionality of myGov and Single Touch Payroll. The service should:

- allow members to register online their choice to open, close or consolidate accounts when they are submitting their Tax File Number on starting a new job
- facilitate the carryover of existing member accounts when members change jobs
- collect information about member choices (including on whether they are electing to open a default account) for their employer and the Government.

There should be universal participation in this process by employees and employers.

#### **DRAFT FINDING 3.2**

There are strong grounds for requiring a fund that wins default status for contributions of new default members to extend the same fees and service terms to all its existing members of the default product.

#### **DRAFT FINDING 3.3**

The default product in all models will focus on the accumulation stage and include investment, administration of member accounts and intrafund advice. It will be a simple and low-cost (but not conservative) product aimed at the needs of those who are disengaged from the system.

- A bundled insurance product will not be a factor in the selection of products and is best addressed through regulation and regulator oversight.
- Funds will primarily compete on long-term net investment returns and costs, subject to meeting a threshold quality of service, not on the quality or range of ancillary services per se.

# **DRAFT FINDING 3.4**

The desirable frequency for the selection process is between four and eight years, with the greater frequency best used in the early period.

#### **DRAFT FINDING 3.5**

The selection of eligible default products should be administered by a government body, and be subject to strong governance rules. The decision-making body must:

- · have a strong focus on fund member interests
- have sufficient expertise to evaluate products
- be independent and free of real or perceived conflicts of interest
- have processes that are transparent and afford procedural fairness
- be accountable for its decisions.

#### **DRAFT RECOMMENDATION 3.3**

The Australian Government should introduce a formal framework that specifies the process and obligations of trustees when making or considering merger proposals. As part of the framework, trustees would be required to disclose all merger attempts involving their fund, as well as the reasons for any decisions.

## **DRAFT FINDING 5.1**

Relative to the baseline, the assisted employee choice model would:

- significantly reduce the complexity employees face in choosing a product and lead to more employees choosing high-performing products that meet their needs, thereby increasing member benefits
- focus competition on product aspects of value to members, put downward pressure on fees (through greater product comparability) and likely curtail wasteful product proliferation
- better align funds' interests with those of members
- support a stable superannuation system
- have lower search costs for many employees and very low costs for employers, but with government and funds incurring additional costs associated with regulatory structures.

#### **DRAFT FINDING 6.1**

Relative to the baseline, the fee-based auction model would:

- promote member benefits by exerting downward pressure on fees
- focus competition on, and elevate transparency of, member fees
- likely assist integrity due to its simplicity and accountability mechanisms
- be unlikely to compromise long-term stability because the model as designed would not lead to excessive concentration of funds or volatile movement of members and assets
- have slightly lower system-wide costs, mainly due to lower search costs for members.

#### **DRAFT FINDING 7.1**

Relative to the baseline, the multi-criteria tender model would:

- promote member benefits by focusing competition on member satisfaction and long-term net returns
- focus competition on aspects of performance that matter to members, and more generally through the winning bid providing a market-wide performance benchmark
- create risks for integrity due to its vulnerability to subjective judgments, yet on the other hand promote integrity through stronger accountability mechanisms
- not create any material risks to stability, since it is unlikely to lead to excessive concentration or volatile movement of members and assets
- have slightly lower system-wide costs, mainly due to lower search costs for members.

#### **DRAFT FINDING 8.1**

Relative to the baseline, assisted employer choice (with employee protections) — employing both a light filter for mandatory minimum standards and a heavy filter for a preferred default list — would:

- enhance member benefits by increasing the likelihood of members being placed in higher quality products, and reducing the likelihood of them being in a poor product
- promote healthy competition by presenting product providers with incentives to perform strongly against the preferred list selection criteria or compete for corporate tenders and facilitating greater comparability, but there would still be some scope for unhealthy and wasteful marketing to employers
- increase the potential for agency problems given the involvement of employers, although the risk to the integrity of the system would lie primarily in the appointment process for the preferred default list selection panel
- create few stability concerns
- reduce search costs for employees, while increasing search costs for employers and regulatory costs for funds and government.

# Information requests

#### INFORMATION REQUEST 3.1

The Commission is seeking comment from the industry on the effect on fund participation in the competitive process of moving to the first-timer pool of default members.

- Are there any funds that might choose not to participate due to the lower value of the pool, and what is the threshold minimum pool size (per fund) at which this might happen?
- How would the move to a first-timer pool of default members affect the fees and product features that funds would offer when competing for new members?

#### **INFORMATION REQUEST 3.2**

The Commission is seeking feedback on the merits and implementation issues of its proposal to improve transparency around fund merger activity.

- What (if any) complementary regulatory action would be needed to ensure that the framework is effective in promoting mergers and the exit of underperforming funds?
- Are there any likely unintended consequences from introducing the proposed framework? To what extent and how could those unintended consequences be addressed through policy design?

#### **INFORMATION REQUEST 3.3**

The Commission is seeking comment on its approach to, and alternative ways of estimating the size and value of, the turnover and first-timer pools and the benefits from reducing account proliferation due to moving to the first-timer approach.

#### **INFORMATION REQUEST 5.1**

In terms of a shortlist of superannuation products, what evidence is available on the size of the list that would best facilitate the majority of employees to choose a fund that meets their needs?

What specific information should be included alongside such a shortlist to help employees to choose between products? In what format should the information be presented? What evidence is there for how the metrics would assist employees to make decisions?

What institutional arrangements would best suit a last-resort fund? Should it be managed by existing eligible rollover funds or the Future Fund?

Under a system of active employee choice, what would be the costs and benefits of prohibiting funds or related parties from offering prospective members a short-term benefit that is unrelated to the superannuation product? What specific form should any such prohibitions take?

#### **INFORMATION REQUEST 6.1**

Is the format of a first-priced sealed bid with a best-and-final-offer stage and potentially multiple winners the best fit for a fee-based auction? Are there any risks associated with these design elements that have not been identified?

Regarding transparency, what would fall under the exemption of information that, if it were disclosed, could reasonably be expected to have commercially adverse consequences for the bidder?

Could a fee-based auction be designed to facilitate second-order competition between funds on non-fee aspects of performance, such as member services?

#### **INFORMATION REQUEST 7.1**

Which aspects of member services should be included in the tender criteria? Do default members value the same services as choice members?

How should default members be allocated across the set of winning products? Are there problems with sequentially allocating members into products with different investment strategies, fees and services, as is implied by this model? What role could a best-and-final-offer stage play in providing a select number of funds the opportunity to improve their offer?

Regarding transparency, are there any problems with only withholding information that can reasonably be shown to be commercially sensitive? What information would fall under this exemption?

#### **INFORMATION REQUEST 8.1**

What are the main drivers of costs to employers in selecting default products on behalf of their employees? Would a shortlist of preferred default products make this task easier for employers? Is there an ideal minimum number of products that should be nominated on the preferred default list?

Are there other specific criteria in addition to those proposed under the minimum standards criteria that default products should meet to protect members and help to achieve better outcomes for them in the long term?

Would a dual-list approach, allowing employers to select a product from one of two lists, provide them with sufficient flexibility to select tailored default products that best meet the needs of their employees?

Which types of employers prefer to retain a role in default product selection? To what extent are default products or corporate fund offerings considered important benefits offered to prospective employees in competitive labour markets?

# 1 Choice and competition in superannuation

#### **Key points**

- The Commission has been asked to examine new alternative models for a formal competitive process to allocate default superannuation members to products.
  - This inquiry is stage 2 of a 3 stage process, and stems from the Australian Government's response to the 2014 Financial System Inquiry.
- Superannuation has evolved much since compulsory superannuation was first introduced a
  quarter of a century ago. Today's default arrangements evolved historically within the
  workplace relations system, and provide a safety net for employees that fail to make a
  decision given compulsion.
- But while the superannuation system uses a default model to address member disengagement, this system may at the same time have acted to perpetuate that disengagement.
- Competition is a means to an end in superannuation, as in other service arrangements.
   This inquiry is specifically charged with considering how competition can be factored into the design of arrangements to allocate default members in order to enhance efficiency, and thereby member outcomes, in the superannuation system.
- The superannuation system particularly the default segment has unique features.
  - On the demand side, it is characterised by the compulsory nature of contributions, complex long-term decisions, and various cognitive and behavioural biases.
  - On the supply side, there are unique features such as non-traditional barriers to entry (industrial agreements), as well as various forms of regulation.
- The ability for employees to exercise choice is integral to the design of Australia's (predominantly) defined contribution system, and the option to exercise choice is integral to competition. While employee choice in superannuation has evolved over time, and a wide range of funds can compete for new members to join, a substantial share of employees continue to have restricted or no choice of their superannuation fund.
- Complementary policy action (including to extend genuine member choice to all employees)
  will be needed to deliver the full potential of member-driven competition under the
  alternative models developed in this inquiry and under current default arrangements.
- Where employees are not able to make choices in their best interests and exert effective competitive pressure (in the market), there may be a case for a default arrangement. But even here it is still possible to inject competition for the default market as a whole.
- In this report, a formal competitive process for allocating default members constitutes any new alternative process that permits open participation and encourages rivalry between funds to the benefit of members, and involves products being selected based on merit.

# 1.1 What is this inquiry about?

The Commission has been asked to examine alternative models for a formal competitive process to allocate default superannuation members to products. The essence of the task is to develop a workable model, or models, that could be implemented by the Australian Government if deemed desirable following the future review of the efficiency and competitiveness of the superannuation system (which the Productivity Commission will be requested to undertake after 1 July 2017).

This inquiry represents the second of three related pieces of work on superannuation to be undertaken by the Productivity Commission (figure 1.1) stemming from the Australian Government's response to the recommendations of the 2014 Financial System Inquiry (FSI) (Murray et al. 2014).<sup>3</sup> The FSI found that the superannuation system was not operationally efficient due to a lack of price-based competition in the sector. To improve operational efficiency during the accumulation phase of superannuation, the FSI recommended introduction of 'a formal competitive process to allocate new default fund members to MySuper products', unless a review by 2020 finds such a move would be unnecessary (Murray et al. 2014, p. 101).

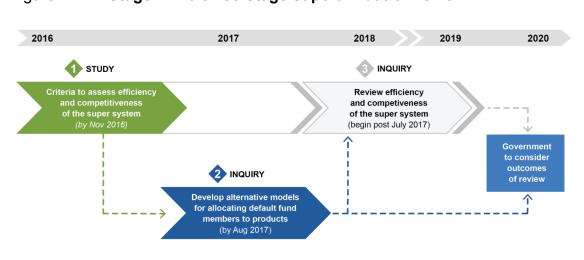


Figure 1.1 Stage 2 in a three-stage superannuation review

#### What is the scope of this inquiry?

The focus of the Commission's task in this inquiry (stage 2) is on developing alternative models for future consideration by the Australian Government. The Commission is not required in this inquiry to reach views on whether alternative models are better or worse than the current default arrangements, nor the merits of the MySuper arrangements or the

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The Commission released its stage 1 study on *How to Assess the Competitiveness and Efficiency of the Superannuation System* on 25 November 2016.

competitiveness and efficiency of the system. These matters will be examined in detail as part of the next phase (stage 3) review of the competitiveness and efficiency of the superannuation system.

The scope of this inquiry is relatively broad. The terms of reference encourage the Commission to consider various types of models that could be applied to allocate default members, to draw on the strengths and weaknesses of approaches used internationally, and to draw on expertise in the field of competitive models.

Notably, the focus of this inquiry is broader than the Commission's 2012 inquiry (PC 2012) into default superannuation funds, which focused on criteria for the selection and ongoing assessment of superannuation funds eligible for nomination as default funds in *modern awards*. In this inquiry, the Commission is considering alternative models for a formal competitive process for allocating default members across the system *as a whole*.

The terms of reference also ask the Commission to develop a process for allocating default fund members to *products*. This is a slight departure from one part of the current default architecture, where modern awards are required under the *Fair Work Act 2009* (Cwlth) to specify default *funds* to which contributions can be made. The reference to funds rather than products in legislation is a result of the history of the superannuation system, which pre-dates the Stronger Super reforms introduced in 2013. From October 2013, superannuation funds have been required to direct all default contributions to a MySuper product authorised by the Australian Prudential Regulation Authority (APRA). All members under previous default arrangements must be transferred to a suitable MySuper product by 1 July 2017 (Australian Government 2011, p. 3).

In practice, under the current arrangements, the terms default *fund* and *product* can almost be used interchangeably. With limited exceptions, only funds that have a MySuper product can be included in the default fund term of an award, and typically a fund can only offer a single MySuper product (Australian Government 2011, p. 4). Consistent with the language of the terms of reference, all of the alternative models assessed in this draft report focus on allocating default members to products (rather than funds). Default fund members consume a certain bundle of services (a product) from a superannuation fund. Furthermore, superannuation funds can offer many different products. For reasons explained further in chapter 3, the alternative models in this report will focus on allocating members to products for the accumulation phase only.

#### Evidence base and further consultation

In keeping with the *Productivity Commission Act 1998* (Cwlth), the Commission has conducted this inquiry using transparent and public processes, with an overarching concern for the wellbeing of the Australian community as a whole. The Commission published an issues paper in September 2016, and has met with a range of interested parties including industry bodies, superannuation funds, specialists, academics, and government officials. The full list of the study participants that the Commission consulted prior to the draft

report is detailed in appendix A. The Commission also received 52 submissions and had 43 meetings with stakeholders in the lead up to the release of this draft report.

In developing this draft report, the Commission has given consideration to all submissions and considered the most relevant available evidence. This includes learnings from international experiences, the fields of behavioural finance and competitive market models, and survey-based evidence, which have added to the Commission's evidence base.

The Commission invites additional comments and submissions on the draft report, and will also be seeking further feedback via public hearings — further information can be found on the Commission's website.

# 1.2 The role and evolution of defaults in Australia

Default arrangements have been integral to the development of Australia's superannuation system. It is useful to explore the role and evolution of, and rationale for, defaults in Australia as a precursor to considering alternative models for allocating default members.

#### The nature of the default market

In a standard competitive market, well informed and engaged consumers make decisions in their own best interests, driving demand for goods or services they value. In turn, suppliers respond to these signals and dynamic rivalry leads to innovations and cost reductions over time. There are several reasons why the superannuation system, and in particular the default segment, does not live up to this textbook ideal.

First and foremost, the system is based on compulsion.

Superannuation, as we know it today, originated from a number of different but related traditions: employer paternalism, industrial agreements and government compulsion. Each of these traditions has one thing in common: compulsion. (UniSuper, sub. 20, p. 4)

The compulsory nature of contributions can act to limit the demand-side pressure exerted by members. Several mutually reinforcing aspects of the system can further accentuate member passivity and disengagement, such as the complexity of retirement income decisions, long time horizons, various behavioural and cognitive biases, and the costs of active involvement (PC 2016; ISA, sub. 40, p. 56; REST, sub. 23, p. 3).

Many people have little sense of the risks they face; many do not understand probability well; and many do not understand basic concepts in finance ... Even if someone has the knowledge to choose well, the gain from choosing more effectively in any particular month is small, whereas the transactions costs in terms of time are significant. (Barr 2013, p. 73)

While most employees now have the opportunity to choose the superannuation fund and product they wish to direct their compulsory contributions to, some remain unable to

choose (although estimating the precise number of people in this situation is not straightforward (box 1.1)). In any case, most employees (even when they can) do not appear to exercise choice for a superannuation product. The available survey evidence suggests up to two-thirds of fund members stay with the default nominated for them by their employer (PC 2016, p. 199) — hence they can be considered part of the *default segment* of the system — and recent research indicates that about one-quarter of those in a default plan are there by conscious choice (Butt et al. 2015, p. 14). *Trust* in system participants has also been identified as a primary motivating factor for people defaulting (AIST, sub. 28, p. 3; Butt et al. 2015; CIFR, sub. 7, p. 3). The evidence also suggests that relatively few members switch once they are in a fund (ISA, sub. 40, pp. 42–43), and CHOICE (sub. 31, p. 7) indicated that superannuation switching rates are below those for other financial and utility products.

#### Box 1.1 The evolution of employee choice in superannuation

The ability for employees to choose their superannuation product has evolved over time. From 1 July 2005, most employees have had the right to choose the superannuation fund to which their contributions are made, including those in modern awards. The main exceptions are those employed under some workplace determinations and enterprise agreements (chapter 3; Fear and Pace 2008, p. 12; O'Dwyer 2016b, p. 23; PJCCFS 2007, pp. 16–17). Previous estimates have indicated that about 20 per cent of the Australian workforce still do not have choice of fund (ASFA 2012, p. 7; Clare 2010, p. 9; Fear and Pace 2008, p. 12), although it is difficult to verify this figure. Further, these estimates encapsulate people in different circumstances, and where choice of fund might not be guaranteed by legislation, it might (in some instances) still be offered by the employer voluntarily.

In March 2016, the Australian Government introduced legislation that would enable employees covered under enterprise agreements and workplace determinations that are made after 1 July 2016 to choose their own superannuation fund (Australian Government 2016). The Explanatory Memorandum to the Bill noted that while comprehensive data are not available, it cited the Association of Superannuation Funds of Australia estimate in 2012 that '20 per cent of employees continue to have restricted or no choice of superannuation fund', which the Australian Government equated to approximately two million individuals (O'Dwyer 2016b, p. 15). The Australian Government assumed, based on Department of Employment figures, that its proposed legislative changes would extend choice to up to 800 000 employees under enterprise agreements and workplace determinations (O'Dwyer 2016a, 2016b, p. 23). This legislation lapsed at the prorogation of the 44<sup>th</sup> parliament and has not yet been re-introduced.

Unlike the accumulation phase, the need to make an active choice (in other words, no default system) exists in the retirement phase of superannuation, though the Australian Government recently announced it would seek policy changes in this area (chapter 3). In a recent research project examining superannuation policy for post-retirement (PC 2015a, p. 2), the Commission found evidence that despite people being afforded much flexibility in the way they drawdown their superannuation once they have access, most retirees are prudent in their drawdown behaviour (including those that take lump sums). The necessity to make choices is evidently better established in members' minds by the time of retirement.

#### **Current default arrangements**

The rules and processes surrounding how default members are allocated to a default product vary significantly across awards, agreements, contracts and other employment arrangements (figure 1.2). These arrangements have largely evolved through the industrial relations system (box 1.2).

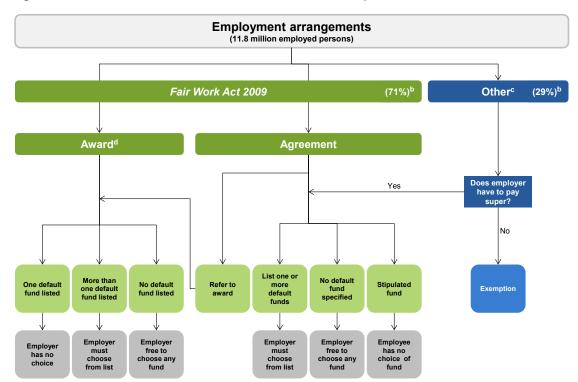


Figure 1.2 **Default funds**<sup>a</sup> in Australia's workplaces

<sup>a</sup> All default funds must offer a MySuper product or be an Exempt Public Sector Superannuation Scheme. <sup>b</sup> Numbers in brackets are the approximate proportion of total employed persons under the specified work arrangements, sourced from (PC 2015b, p. 5). <sup>c</sup>This includes state-based systems and common law employment contracts. <sup>d</sup> Currently, the vast majority of the 122 listed current modern awards stipulate one or more default funds from which an employer may select one. Where an award does not list any funds, employers are free to choose any fund with a MySuper product as their default. Where there are grandfathering provisions in a modern award, employers can generally continue to make contributions (on behalf of their employees) to their previously selected default fund, even if it is no longer listed in the award (PC 2012, p. 6).

### Box 1.2 The origins of default funds and products

The obligation on employers to make superannuation contributions (on behalf of their employees) progressively became part of various industrial awards during the 1980s. In 1992, compulsory employer contributions were extended to almost all employees with the introduction of Commonwealth legislation to establish the Superannuation Guarantee.

Existing default arrangements evolved in the context of the workplace relations system. Specific superannuation funds were named in awards when superannuation became an industrial matter in national wage bargaining in the 1980s. Several industry-based funds were established as not-for-profit entities to cater for employees in specific industries.

From 1 July 2005, most employees have been able to choose their superannuation fund and (in effect) the product to which they want their contributions directed (box 1.1). Where employees have not made a choice, the funds named in awards have become the default option in many cases. Default arrangements provide a safety net for employees that fail to make a decision, in view of the compulsory nature of superannuation.

Various rationales have been put forward as to why the majority of people fail to make a decision, creating the need for defaults. These include the inherent complexity that individuals face in making decisions about retirement incomes, leading to fears that employees who were disengaged or ill-equipped to make decisions could make poor decisions, which in turn would increase future reliance on the Age Pension. Default arrangements were also seen as reducing the cost and complexity for employers of complying with their Superannuation Guarantee obligations (given concerns, particularly from unions, about non compliance by some employers in the absence of relatively straightforward default arrangements).

The superannuation system has evolved in a myriad of ways since compulsory superannuation was first conceived. For example, several industry funds have merged to create larger funds with more diverse memberships, and many of these industry funds have become public-offer funds. More broadly, there has been significant consolidation in the number of institutional funds from about 4700 to 250 funds over the 1997 to 2016 period. There have also been accompanying improvements in transparency. MySuper is intended to be a simple and cost effective superannuation product replacing previous default products. It is designed to ensure members do not pay for any unnecessary features they do not need or use. MySuper products are intended to have a relatively standard set of features to enable members, employers and market analysts to compare funds more easily.

Sources: Australian Government (2011); Productivity Commission (2012, 2016); Shorten (2011); Vision Super (sub. 4, pp. 4–5); Weaven (2016).

There are up to four 'third parties' involved in the selection of default products for employees that fail to make an active choice (at least as currently envisaged under the legislated arrangements) — the regulator (APRA), an expert panel within the Fair Work Commission (FWC), the full bench of the FWC and, finally, employers (figure 1.3).

Employers' level of discretion in the product selected for their employees depends on the specific employment arrangements in place. For example, they could effectively have *no choice* (where an employee's award prescribes one fund) to *wide-ranging choice* (where an employer can select any authorised MySuper product).

A stylised view **FWC**<sup>a</sup> **APRA Employers** (Process not yet finalised) MySuper authorisation Product choice **Expert Panel Full Bench**  License RSEs Select eligible Review default fund Prescribed or limited MySuper products terms of awards choice in award or Standard features<sup>b</sup> and compile the Default List agreement Specify (typically) Enhanced trustee 2-15 products in Full choice, select from any MySuper product Annual reporting on based on factors set 4-yearly review out in legislation<sup>c</sup> strategy & scale

Figure 1.3 **Decision steps in selecting default products** 

In some cases employers can select from any MySuper product

The process set out in legislative changes introduced in 2013 — to establish a two-stage process within the Fair Work Commission (FWC) to determine a default list of products and review those to be included in each award — has not yet been finalised (FWC, sub. 51, p. 2). This includes that a MySuper product must be based on a single diversified investment strategy (which may be a life-cycle strategy) (s. 29TC of the SIS Act), adhere to rules and restrictions on product fees (Division 5 of Part 2C of the SIS Act), and a requirement that the product must incorporate life and total and permanent disability insurance on an opt out basis (s. 68AA of the SIS Act). CApplications must include a range of information about the applying fund and its standard MySuper product performance. The relevant criteria are set out in s. 156F of the FWA. CA standard MySuper product satisfies this second stage test if it is on the Default List and the FWC is satisfied that specifying it would be in the best interests of the default fund employees to whom the modern award applies (s. 156H of the FWA).

Sources: APRA (2012); Australian Government (2011, pp. 5–6); Fair Work Act 2009 (Cwlth) (FWA); FWC (2016); Superannuation Industry (Supervision) Act 1993 (Cwlth) (SIS Act).

Fund trustees are subject to fiduciary and statutory obligations to operate in the best interests of their members (CIFR, sub. 7, p. 2; Kinetic Superannuation, sub. 45, p. 2). In practice, these obligations translate into a detailed set of prudential standards, reporting requirements, supervisory frameworks and other regulatory guidance material provided to trustees, which include additional duties for MySuper products (APRA, sub. 33, pp. 2–3). Although employers are responsible for selecting a default product for their employees, they do not face similar legal obligations to act in the best interests of employees (ASIC, sub. 41, p. 2). They are, however, provided with regulatory guidance on a range of matters such as on illegal inducements and factors to consider in default fund selection, and are required to comply with their Superannuation Guarantee obligations.

#### Participant views on current default arrangements

Several inquiry participants expressed concern that the current supply-side arrangements in the default segment (particularly their interaction with industrial awards and agreements),

restrict competition and innovation which could benefit members, and are duplicative and inefficient (for example, Colonial First State, sub. 25, p. 1; FSC, sub. 38, p. 3, p. 31).

Other participants suggested that the current default arrangements have served an important purpose by linking default members to funds with a culture of serving others and operating in the best interests of members, not shareholders or other related parties (for example, ISA, sub. 40, pp. 7, 25; Vision Super, sub. 4, pp. 6–9). In support of this view, many of these same participants highlighted empirical evidence of superior returns delivered by not-for-profit funds relative to for-profit funds, and for default funds nominated in modern awards particular. Other participants noted that there is significant diversity in investment performance even within the population of current MySuper products (box 1.3).

#### Box 1.3 Selected participants' views on default sector performance

The relative performance of superannuation funds (and products), and how these are best measured and presented, is a source of ongoing debate in the superannuation system and examination in the literature (PC 2016, pp. 112–130). This box focuses on views raised by inquiry participants about the relative performance of the 'default segment'.

Industry Super Australia (sub. 40, p. 10) noted (based on SuperRatings data) that over the past 10 years, funds named in modern awards as eligible *defaults* have outperformed *non-default options*, with average annual net returns of about 5.9 per cent compared with 4.9 per cent. The Australian Institute of Superannuation Trustees (sub. 28, pp. 15–16) noted that a list of top performing funds provided by Chant West for the 10 years to 30 June 2016 included funds that were all default funds in modern awards.

Some participants also noted the relative superior investment performance of industry-fund default products within the default segment. For example, Industry Super Australia (sub. 40, p. 46) noted that over the past 10 years, average net returns (for products listed within awards) were 6.0 per cent for industry funds compared with about 4.0 per cent for retail funds, while the Australian Institute of Superannuation Trustees (sub. 28, p. 15) cited broadly similar comparative results.

The Financial Services Council (sub. 38, p. 32) noted evidence that — since MySuper started in 2013, and over the past five and 10 years — there has been significant variation in the performance of different default products (now MySuper products) that are listed in modern awards as default funds.

Based on the data it collects, the Australian Prudential Regulation Authority (sub. 33, p. 2) said:

... since 1 July 2013, there has been considerable variation in net returns and fees for different MySuper products, leading to a wide range of outcomes for members across these different products. While there has been some evidence of reductions in fees and costs since MySuper products were introduced, particularly for products with previously very high fee levels, there is clearly room for further improvement. Further, while many MySuper products have achieved their net return targets over the past few years, some have fallen well short.

The Commission's analysis of APRA (2017d) product-level net returns data<sup>4</sup> showed that while the top quartile MySuper products is dominated by industry funds, the bottom quartile is populated by a roughly even number of industry, retail and corporate funds. Admittedly this analysis is much caveated by data limitations, but it does suggest that *poor* performance is not necessarily dictated by fund type. APRA recently noted that it is looking closely at the bottom performing funds (across a range of factors in addition to net returns), of whom a large proportion are not-for-profit and industry funds (Rowell 2017, p. 28).

# Most participants consider there is an ongoing need for defaults ...

Inquiry participants from within the superannuation industry generally suggested that some form of default arrangements will continue to be a necessary feature of the system for the foreseeable future (if not into perpetuity) irrespective of the process for allocating default members (for example, AIST, sub. 28, p. 4; ASFA, sub. 24, p. 3; ISA, sub. 40, p. 8; Vision Super, sub. 4, p. 4). Four inter-related factors were generally cited as reasons for the ongoing need for default arrangements.

- The compulsory nature of superannuation.
- The level of employee/member disengagement (especially for young members).
- The complexity and costs associated with members making decisions.
- The inability of some members to make good decisions due to a lack of financial literacy or the influence of various behavioural or cognitive biases.

On this basis, most participants were highly sceptical of (or explicitly rejected) any model framed around active member choice without a default safety net (for example, CIFR, sub. 7, p. 5; ISA, sub. 40, p. 55), at least in the near term (for example, FSC, sub. 38, p. 3).

#### ... but views differed on the allocation mechanism

Several inquiry participants favoured the continuation of an administrative allocation model for allocating default members within the industrial relations system (for example, AIST, sub. 28, pp. 4–5; ISA, sub. 40, p. 5). Participants noted that the current system already has elements of an administrative and market-based model — such as the legislated (but not yet finalised) FWC expert panel evaluation process for being listed in an award — and that this system should be given an opportunity to operate (for example, AustralianSuper, sub. 19, p. 1; REST, sub. 23, p. 2). Some participants also emphasised that employers should still be considered central to the allocation process within this framework (for example, AHA, sub. 6, pp. 3–4; ISA, sub. 40, pp. 30–31, 44; UniSuper,

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Data availability and consistency limited the Commission's analysis to 76 products over 11 quarters to 31 December 2016.

sub. 20, pp. 8–9) and that MySuper authorisation is an insufficient filter (ISA, sub. 40, p. 5; REST, sub. 23, p. 5).

Other participants favoured opening up access to default members to a wider range of potential suppliers using the MySuper authorisation as the starting point for a filter, with scope to enhance it (for example, FSC, sub. 38, p. 21). There were different views among this group on whether employers should be compelled to select a default for their employees, the scope for treating large and small employers differently, or whether another party should be designated the allocation task (for example, CIFR, sub. 7, pp. 6–7; FSC, sub. 38, p. 21; WSSA, sub. 11, p. 3). However, the general view of this group (explicitly or implicitly) was to consider models where defaults are administered outside the industrial relations system.

Use of an auction or tender model as part of a default mechanism was rejected by most industry participants (discussed further in section 1.3). More detailed participant views on specific models are outlined in the relevant chapters.

# 1.3 How are competition and choice relevant to the default segment of the system?

The Commission has been tasked to develop alternative models for a new *formal* competitive process for allocating default members. Competition is a means to an end, with the ultimate objective being arrangements that promote members' best interests and community wellbeing.

Several inquiry participants questioned the merits of focusing on a formal competitive process (and competition in superannuation more generally) as a desirable objective for superannuation, and in particular for default members (for example, ISA, sub. 40, pp. 7, 51). Others supported the introduction of greater competition in the processes used to select eligible default funds and products, and see expanded active member choice (even if unlikely in the near term) as an objective worth striving towards (for example, FSC, sub. 38, p. 3).

This section explores the potential role of competition and choice in the superannuation system (and the relevance for the design of alternative models), as a precursor to outlining the Commission's approach to assessing alternative models in chapter 2.

# Competition and member choice are relevant to default members

Competition — meaning rivalry among providers — can be an important force for promoting efficiency. It will generally be effective where the opportunity exists for incentives and consumer pressure to address price and quality preferences of potential members. Through this process, competition can lead to reduced fees, improved service quality and product innovation. Competition can also 'weed out' inefficient or

unsustainable providers. However, competition in superannuation may not always promote outcomes consistent with members' best interests or community wellbeing. It will generally be less effective where members are not well informed or engaged, preferences are not identified, products are difficult to compare in a meaningful way or where providers compete on features of little value to consumers.

It is also worth considering what is often observable in markets where competition is not present: incentives are skewed towards interests other than those of consumers. While it is always possible to point to examples of selfless service providers, with large mandated cash flows in superannuation, risks remain that practices will not always coincide and evolve with the best interests of disengaged individuals. The need to innovate or to anticipate shifts in consumer needs is weaker without the threat of members moving their contributions.

Several inquiry participants that were sceptical about the use of competition as a force for member interests appeared to put most faith in the wisdom of trustees as capable of addressing these needs without any greater incentive than their current fiduciary and statutory obligations. This inquiry will provide an opportunity to test that proposition more fully.

There are various ways that principles of competition and member choice can inform the design of alternative arrangements for allocating default members. An important first step is to consider the *nature* of competition and the *functional* level of the market at which it can be targeted. Broadly, competition could be promoted in one of two ways:

- competition *in* the market which refers to competition based on conventional demand- and supply-side interactions between employees (members) and trustees (funds)
- competition *for* the market which refers to competition between funds via some form of formal process to earn the right to gain access to default members.

# Member choice can drive competition in the market

Promoting competition in the market relies on consumers being able to make choices. As noted above, while most employees in the superannuation system already have the opportunity to choose which superannuation product their contributions are paid into, some employees remain unable to choose (box 1.1). Most participants supported members' freedom to choose their fund and product (for example, AMP, sub. 42, p. 1; IPA, sub. 17, p. 12; Mercer, sub. 15, p. 4), although some emphasised that choice can lead to poorer performance outcomes (for example, ISA, sub. 40, p. 8).

Several participants noted that employee choice is already driving competition *in the market* to benefit members. For example, AIST (sub. 28, p. 27) cited analysis from Chant West that suggests there is considerable pressure on funds to attract and retain members and the fees funds charge represent an important point of difference (especially under

MySuper arrangements). Competition outside the boundaries of the default segment — such as from self-managed superannuation funds — further contributes to the competitive dynamics in the system (Ai Group, sub. 21, p. 1; REST, sub. 23, p. 4).

Other participants were sceptical of the level of member-driven competition. For example, Kinetic Superannuation noted that:

As identified by recent inquiries, the Australian superannuation industry lacks a strong consumer-driven competition that is particularly pronounced in the default fund market. This contributes to perceptions of inertia and complacency in the default fund system. (sub. 45, p. 1)

Downside risks of promoting greater competition and choice were also highlighted by participants. For example, inquiry participants indicated that models that seek to promote greater competition may lead to: increased funds' marketing and distribution costs (AIST, sub. 28, p. 50; REST, sub. 23, pp. 3–4), more sales driven switching that draws members into underperforming products (ISA, sub. 40, p. 5, 41), higher member (or employer) search costs (AIST, sub, 20, p. 30), and exposure of employees and (particularly small) employers to choices they are ill-equipped to make (CSA, sub. 35, p. 2). These can apparently occur despite obligations already imposed on trustees to act in members best interests

It can also be reasonably argued that there is a great deal of choice in the superannuation system already — perhaps too much for many new members to cope with, contributing to persistently high use of the default option. And there is little doubt that freedom of choice includes the freedom to make mistakes.

Another issue raised by participants is that the present system may be unable to prevent an employer coercing its employees into a particular fund, perhaps based on inducements the business receives that do not benefit the member. While legislative provisions are designed to prevent funds from offering employers inducements<sup>5</sup>, participants had differing views on their efficacy (for example, FSC, sub. 38, p. 13; ISA, sub. 40, p. 41). And the regulator, the Australian Securities and Investments Commission noted that:

... the real prospect remains of employers selecting a fund as a result of inducement, including lawful inducements and on the basis of competition directed to the employer rather than to the quality of the product for retirement income purposes of the employees. (sub. 41, p. 4)

Improvements to member choice in the future are thus likely to be a *necessary* but *insufficient* condition to help realise the full potential of member-driven competition in the superannuation system. Such improvements might include, for example, the removal of restrictions in enterprise and workplace agreements that limit employees' choice of fund, or further action to discourage coercion. A maturing system may improve the scope for member-driven competition. Thus, barriers to relying on competition include a potential dependence on complementary policy actions, rather than the simple opening up of more choice. The policy choice is more complicated than it might first seem.

<sup>&</sup>lt;sup>5</sup> Section 68A of the Superannuation Industry Supervision Act 1993 (Cwlth).

#### A maturing system may improve the scope for member-driven competition

The decision to choose a superannuation fund or product, or stay in the default, is not the only time members can exercise choice in order to drive competition. The ongoing process of monitoring their fund's performance, comparing market offerings and (and at the extreme) switching providers (or deciding stay with their provider) are all opportunities to engage. Members are also more likely to become engaged with their superannuation as they get older and approach retirement (PC 2016, p. 192). Therefore, as the system and member population matures, a greater proportion of members will, in effect, act as agents for competitive pressure intensifying on funds' product and pricing decisions.

The system has matured in various other ways over the past quarter century. For example, employees and employers are more familiar with the concept of superannuation and employees switch jobs more often (on average) and therefore have more prompts to potentially make decisions about their superannuation (ABS 2013, 2016). There has been some consolidation in the funds market (box 1.2). Funds are also utilising new ways — such as mobile phone applications and social media platforms — to interact with members and to capture new members (Frost 2016; Willis Towers Watson 2016).

Superannuation policy settings have also evolved. As noted above, employee choice was extended in 2005 (box 1.1) and regulations introduced as part of MySuper have also enhanced the ability for members, employers and market analysts to compare products more easily. Another system change has been the introduction of SuperStream and Single Touch Payroll which aim to streamline and simplify the manner in which employers interact with superannuation funds and comply with their Superannuation Guarantee obligations.

Notwithstanding the system evolving in various ways, several participants suggested that the factors which underpin the rationale for defaults have not changed — namely, the inherent complexity of decisions about retirement income, employee disengagement and employees not feeling qualified to make an informed decision (for example, AIST, sub. 28, pp. 47–49; Vision Super, sub. 4, p. 4). Participants also identified areas where the system could be further improved, including:

- centralised information to enable more meaningful MySuper product comparisons, fund selection and consolidation (CHOICE, sub. 31, p. 9; WSSA, sub. 11, p. 2)
- member education on financial and superannuation issues (WSSA, sub. 11, p. 5)
- more effective design and enforcement of regulation in particular areas, such as employer inducements and disclosure obligations (AIST, sub. 28, pp. 23–24; ISA, sub. 40, p. 41).

The factors which signal a maturing system do not necessarily suggest there will be no role for defaults in the near future, or that a particular type of alternative allocation model should take precedence in this inquiry. However, the above factors provide important context for the development of new alternative models which could be deemed workable.

They also suggest that some of the earlier concerns which formed the basis for the need for defaults — such as a lack of transparency and limited member choice — simply do not hold the same sway today. In other words, the Commission needs to develop alternative models to meet the needs of superannuation members of the future.

Further, while the superannuation system uses a default model to address member disengagement, this system may at the same time have acted to increase or perpetuate that disengagement (PC 2016, p. 38). Some participants in this inquiry noted that member disengagement can, in part, be attributed to the existing institutional settings, including the operation of the current default arrangements. For example, the Financial Services Council said:

... in evaluating consumer engagement and behavioural biases, it would be remiss of the PC to conclude that consumers will never be engaged with the superannuation system. The current system of having a default model by definition creates an incentive for consumers to be disengaged. (sub. 38, pp. 7–8)

To better understand how employees would react in a world where there was a greater reliance on them to choose their superannuation product, the Commission is undertaking an experimental survey of superannuation decision making. The results and analysis will be made publicly available (upon completion) and will also be incorporated in the Commission's final report.

# Where used, defaults need to be supported by clear objectives and effective regulation

There is a complex interplay between defaults and member engagement, which has implications for the ultimate goal of a default system. Some default models may be designed with reference to member engagement, namely to nudge default members towards taking active decisions to shift out of their default fund or product — for example the KiwiSaver default model in New Zealand (appendix B).

The current default arrangements in the Australian system are framed around the simpler objective of meeting members' best interests — including through the initial product they are allocated to — rather than to nudge them towards active choice per se. In the presence of a default system where other agents are making decisions on behalf of members, it is imperative that those agents face clear objectives, and in the context of the Australian system, are subject to explicit and enforceable obligations to act in members' best interests.

As noted above, fund trustees have statutory and fiduciary obligations to operate in the best interests of their members. Although employers are responsible for ultimately selecting a default product for their employees, they do not face similar legal obligations to act in the best interests of employees. Inquiry participants suggested that changes to current default arrangements — such as requiring employers to choose from a long list of products — would impose significant costs on employers (for example, REST, sub. 23, p. 14).

#### **DRAFT FINDING 1.1**

Complementary policy action (including to extend genuine member choice to all employees) will be needed to deliver the full potential of member-driven competition under the alternative models developed in this Inquiry and also under current default arrangements.

#### **DRAFT FINDING 1.2**

Where there is third-party involvement in the selection of a default product, there needs to be effective regulation or arrangements in place to ensure these third parties act in the best interests of members.

# A competitive process can stimulate competition for the market

Promoting competition *for the market* may be desirable where it is not feasible to promote effective competition in the market, such as due to barriers to entry and exit, or monopoly supply conditions.<sup>6</sup> It may best be thought of as a way of encouraging the generation of beneficial variations to products in return for a fixed percentage of new member inflows.

Typical ways to promote competition for a market include a tender or auction process. These mechanisms can encourage participants to make a competitive (service and price) offering for initial rights to the market, and incentives to continue to act in a competitive and efficient manner over time where the process is repeated regularly (chapters 6 and 7). In this way, regular competition for the market also means it becomes contestable.<sup>7</sup>

Tenders and auctions are widely used in the public and private sectors to procure a broad range of products and services. Tenders, in particular, already feature in elements of the Australian superannuation system, for example, the use of corporate tenders by employers and some funds' tendering of administration and insurance providers (REST, sub. 23, p. 4).

There was near universal agreement among participants across all parts of the industry — industry and retail superannuation funds included — that it would *not* be desirable for the Commission to contemplate a tender or auction model for the selection of default products and the allocation of members to those products (box 1.4). Only a few participants saw merit in the use of a tender-type mechanism for the allocation of default members under

Promoting competition for the market could also go hand-in-hand with efforts to promote competition in the market, such as a tender process followed by a focus on member choice.

Contestability can be defined as the degree of ease with which firms can enter or leave a market reflecting the level of potential competition. In a contestable market the threat of new entrants causes the incumbent firms to operate at levels approaching that expected in a competitive market (Industry Commission 1996, p. xix).

different models (CMD, sub. 18, p. 2; IPA, sub. 17, p. 7, Kinetic Superannuation, sub. 45, p. 1).

### Box 1.4 Participant concerns about auction and tender models

Inquiry participants raised a wide range of concerns about the potential use of an auction or tender model to allocate default members to superannuation products.

- A narrow focus on fees would lead to incentives for funds to cut service quality and shift to low-cost, passive investment strategies that may not maximise long-term net returns (for example, IFAA, sub. 13, pp. 3, 8; ISA, sub. 40, p. 54).
- These mechanisms would invite commoditisation when tailoring of products to meet diverse member needs and innovation is needed (for example, AMP, sub. 42, p. 4; ASFA, sub. 24, p. 13; CIFR, sub. 7, p. 5).
- A tender for a single fund that is held infrequently would destroy competition because of a lack of possible participants (ISA, sub. 40, p. 54), and a national tender or auction could lead to a much more concentrated market in the long term with adverse implications for fund viability and competition (for example, CSA, sub. 35, p. 7; UniSuper, sub. 20, p. 7). It would be of concern if the process was 'used as a de facto tool to achieve fund consolidation' (IFAA, sub. 13, p. 5).
- The tender model introduced in Chile reduced administration fees for default members but has not led to better member outcomes (including investment returns) and is unlikely to in the long term (AIST, sub. 28, p. 3; FSC, sub. 49, p. 1; ISA, sub. 40, pp. 12–13). The Australian default system substantially outperforms the Chilean system (ISA, sub. 40, p. 11).
- These mechanisms introduce the risk of gaming (for example, ASFA, sub. 24, p. 13; First State Super, sub. 26, p. 1; FSC, sub. 38, p. 30) and, for an auction model in particular, tacit collusion (for example, FPA, sub. 29, p. 11; FSC, sub. 38, p. 30).
- There are high costs associated with funds participating in these types of processes, and for administering them (for example, ASFA, sub. 24, p. 14; AustralianSuper, sub. 19, p. 3).

The ability for this issue to unite an otherwise disparate set of industry voices against the introduction of an auction or tender model may, in itself, be instructive. Notwithstanding that there may be legitimate concerns about the suitability of various tender models conducted overseas, it may also suggest that, given the massive flows of mandated contributions at stake, there are rents to be protected by funds, which should be recovered for the benefit of members. It certainly requires some sceptical thought from a policy-maker's perspective, and thus some analysis from the Commission on alternative and workable models. And, in any event, this is what the terms of reference require.

At the outset, some concerns raised about the design of a tender or auction model appear less than compelling. For example, concerns about gaming need to be tempered by the fact that funds (and trustees more specifically) would still be subject to a range of statutory and fiduciary duties which bind all fund trustees (Kinetic Superannuation, sub. 45, p. 2). And collusion between proponents is a difficult proposition to argue other than in the abstract, with a cohort of potential participants numbering in excess of 100.

Other participant concerns raise more substantive issues which will require careful thought, evaluation and model design mitigation in this inquiry — for example, funds' incentives to shift to low-cost investments. Chapters 6 (fee-based auction) and 7 (multi-criteria tender) provide more detail on participants' views, the likely materiality of specific risks, and the ways they could be mitigated (if at all).

Auctions and tenders have been used overseas (in Chile and New Zealand; appendix B), and in the Northern Territory (chapter 7). These experiences provide useful evidence for the Commission's consideration and iterative development of alternative models afforded by this inquiry.

### A new formal competitive process does not necessarily mean an auction or tender

The terms of reference ask the Commission to consider alternative models for a formal competitive process for allocating default members, and indicate it 'may consider auction, tender and other types of competitive processes'. The focus of this inquiry on *a formal competitive* process received mixed reactions from inquiry participants.

Some expressed concern that it favoured market-based models, such as a tender or auction. For example, Industry Super Australia said:

It is not appropriate for the Inquiry to insist that a model includes a "competitive process" because, as the Commission has elsewhere acknowledged, competition is only a means to an end. An Inquiry that required the default selection model to be a competitive process would place form over substance. (sub. 40, p. 51)

The use of the term appropriate is odd in this context — it is strange in a policy review context to imagine there is something improper about considering an idea. And indeed, the terms of reference seek such consideration

CIFR (sub. 7, p. 2) submitted that focusing on models which are based on a formal competitive process narrowly presents the issue as a matter of the *mechanism* by which default members are allocated, whereas *who chooses* is the more important issue given the nature of the default superannuation segment and default members.

Other participants appeared to interpret models for a formal competitive process in a broader sense. For example, REST (sub. 23, p. 4) submitted that the current administrative model for allocating default members already has elements of a market-based model, such as the proposed process for being listed as a default fund after consideration by an expert panel. The Australian Institute of Superannuation Trustees submitted that:

The framework proposed by the Commission requires a competitive process to determine which funds are eligible to be used as default funds. AIST has no difficulty with a competitive process, provided it is correctly framed and will deliver a result in the best interests of fund members. (sub. 28, p. 25)

Rather than adopt a narrow approach, in developing alternative models in this inquiry the Commission has taken a broad interpretation of what constitutes a formal competitive process. In essence, the Commission considered any new alternative process that is relatively open, capable of encouraging rivalry between providers in order to generate competitive tension which influences the products and services funds offer, and where there is some basis for objective and independent assessment about products based on merit. The processes designed would need to:

- be contestable for efficient and innovative providers to become eligible to supply default products
- improve competitive tension to members' advantage in the default market (and possibly beyond it)
- encourage persistent under-performers to exit.

Based on this definition, the Commission has examined several types of models in this draft report, including those based on an administrative filter with employer choice, a fee-based auction, a multi-criteria tender, or assisted employee choice. An important design consideration in each model is who has responsibility for making decisions (chapter 3).

#### **DRAFT FINDING 1.3**

For the purposes of this Inquiry, a formal competitive process for allocating default members constitutes any new alternative process that permits open participation (contestability), encourages rivalry between funds (competition) to the benefit of members, and involves products being selected for members based on merit.

# 1.4 A guide to the rest of the report

This report consists of an overview, eight chapters (including this one), and two appendixes. Chapter 2 outlines the Commission's assessment framework for assessing alternative models. Chapter 3 outlines the Commission's approach to the development of alternative models for assessment, including the common foundations across all models. Chapter 4 details the Commission's no defaults baseline that alternative models will be compared against. The next four chapters examine the alternative models against the assessment framework outlined in chapter 2.

- Chapter 5 examines the assisted employee choice model.
- Chapter 6 examines a fee-based auction model.
- Chapter 7 examines a multi-criteria tender model.
- Chapter 8 examines an assisted employer choice (with employee protections) model.

Appendix A outlines the Commission's public consultation process.

Appendix B provides background on retirement income systems and default arrangements in Chile, New Zealand, the United Kingdom and Sweden.

# 2 The Commission's assessment framework

#### **Key points**

- The default segment (as best measured) represents \$474 billion as at June 2016,
   23 per cent of the about \$2 trillion in the superannuation system, and importantly, about two-thirds of fund members.
- In assessing new alternative models, primary consideration will be given to whether each
  model is capable of meeting members' best interests and community wellbeing. The
  assessment will be mostly qualitative given the developmental nature of this inquiry to
  identify workable alternative models.
- More specifically, five model assessment criteria will be applied.
  - Member benefits: whether the model creates incentives for funds to deliver default products that maximise long-term net returns and allocate members to products that meet their needs.
  - Competition: the extent to which the model can harness the benefits of open participation and rivalry between funds to drive innovation, cost reductions and improved long-term outcomes for members.
  - Integrity: whether the model promotes a high degree of integrity in the selection, filtering, allocation, and in the behaviour of system participants.
  - Stability: whether the model is likely to create problems or risks which have the potential to develop into significant systemic problems across the system.
    - ... Churn and the exit (or takeover) of underperforming funds do not necessarily represent stability concerns, and could instead be a sign of healthy competition delivering higher long-term net returns.
  - System-wide costs: the impact the model would have on overall system-wide net costs taking into account the impacts on members, funds, employers and government (including the implications for future reliance on the Age Pension).
- A baseline of no default arrangements will be applied. It is the only objective baseline that
  can feasibly expose the relative abilities of alternative models to address today's problems
  rather than past issues (some of which may no longer be relevant). It is not an alternative
  model.
- In this inquiry, alternative models will need to beat the baseline against the assessment criteria.

This chapter outlines the approach the Commission will take in assessing the merits of new alternative models. This includes specifying the objective of this inquiry (section 2.1), the model assessment criteria (section 2.2) and the baseline that will be applied as the

reference point in the analysis (section 2.3). Chapter 3 outlines the approach to developing models.

# 2.1 The objective of this inquiry

The overarching objective of this inquiry is to identify new alternative workable models for allocating default members to superannuation products. In assessing whether a model is workable or not, the Commission will consider whether it is capable of delivering outcomes which promote members' best interests and (in keeping with the *Productivity Commission Act 1998* (Cwlth)) the wellbeing of the Australian community as a whole. This will be informed primarily by the extent to which a model meets the relevant assessment criteria (outlined in the next section).

The Commission's assessment will necessarily be mostly qualitative given the focus of this inquiry is on identifying workable models.

In many (if not most) cases, a model that promotes members' best interests could also be expected to promote the wellbeing of the Australian community. For example, better investment outcomes for members will ultimately benefit the Australian community as a whole where it improves wellbeing in retirement and reduces fiscal pressure on the government. However, instances may arise where members' interests and those of the broader community do not align. For example, a process where employers are responsible for selecting default products may lead to better outcomes for their employees, but it may also impose costs on employers and regulators. Additional processes that involve significant investments by taxpayers would also need to offer significant community benefit, even if they were in members' individual interests. Trade-offs between member and community objectives will be identified and factored into the Commission's analysis of each new alternative model.

# 2.2 The model assessment criteria

The Commission's issues paper set out five proposed model assessment criteria to evaluate each new alternative model. The criteria were informed by the terms of reference and the efficiency and competitiveness criteria developed for the stage 1 study (PC 2016).

There was mixed feedback from inquiry participants on the criteria set out in the Commission's issues paper. Several participants expressed broad support (for example,

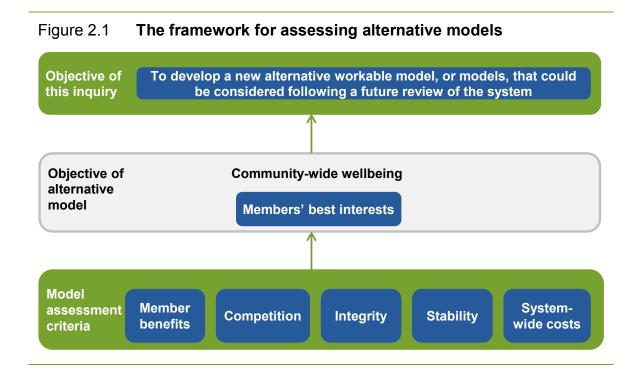
SUPERANNUATION: ALTERNATIVE DEFAULT MODELS

These are distinct from the criteria (or metrics) that would be used within each model to assess the merits of individual superannuation products.

<sup>&</sup>lt;sup>9</sup> The focus of this inquiry is narrower. The criteria developed to examine new alternative models (a component of the system) are designed for this specific purpose.

CSA, sub. 35, p. 4; FPA, sub. 29, p. 3; Kinetic Superannuation, sub. 45, p. 2), although some suggested they were broad and would be difficult to operationalise in places (for example, APRA, sub. 33, p. 1; PwC, sub. 12, p. 3), and that the criterion on members' best interests should supersede all others (for example, ACTU, sub. 34, p. 9; ISA, sub. 40, p. 38). Others queried specific criteria and suggested areas for amendment (for example, FSC, sub. 38, pp. 7–15; p. 17; ISA, sub. 40, pp. 38–39; REST, sub. 23, p. 7).

The following sections outline the Commission's five model assessment criteria, which have been refined based on inquiry participant feedback. The Commission has also sought to provide more guidance on how these criteria will be applied, and potential trade-offs between criteria that may need to be considered. These criteria will be considered and interpreted collectively to inform the overall assessment of each model (figure 2.1).



#### **Criterion 1: Member benefits**

Does the model create incentives for funds to maximise long-term net returns and allocate members to products that meet their needs?

As noted above, a primary factor in examining the merits of new alternative models is whether, and to what extent, each is capable of meeting members' best interests. The Commission flagged in its issues paper that members' best interests equates to consideration of the extent to which an alternative model maximises long-term net returns and allocates members to products that meet their needs.

There was broad agreement among inquiry participants that members' best interests should be paramount in the assessment, and several argued this criterion should supersede all other considerations (ACTU, sub. 34, p. 9; AIST, sub. 28, p. 3; AustralianSuper, sub. 19, p. 1; REST, sub. 23, p. 7; Vision Super, sub. 4, p. 5). For example, ISA submitted that:

Members' best interests could arguably be the sole criterion for evaluating selection processes, since selection processes that are strong on the other criteria, but weak on members' best interests, would be difficult to justify. Moreover, systems that have high integrity, and low system wide costs, for example, should be more efficient in securing members' best interests. (ISA, sub. 40, p. 38)

#### The Australian Council of Trade Unions submitted that it:

... continues to support the Members' best interest (or the ultimate benefit to member) as the principal criteria against which any assessment of alternate models (against the existing default arrangement) should be made. The ACTU does not support 'trade-offs' as such in this evaluation. In specific terms, maximising the net benefit to the member at their retirement is the single, substantive goal which the system should be aiming to produce. (ACTU, sub. 34, p. 9)

There was also broad agreement among participants that serving members' best interests primarily translates into maximising long-term net returns (taking account of risk) as a key input to delivering retirement income (Ai Group, sub. 21, p. 2; AIST, sub. 28, p. 20; AustralianSuper', sub. 19, p. 2; Kinetic Superannuation, sub. 45, p. 2; FPA, sub. 29, p. 3). For example, AIST said:

Members' best interests certainly includes a requirement that an allocated default fund can meet the needs of the cohort of workers to be allocated to a fund. In determining the needs of the employees, a clear focus should be on the expected long-term net returns to members. (AIST, sub. 28, p. 20)

Additional indicators to flesh out an assessment of members' best interests were also suggested. For example, the range and quality of services provided (such as financial advice and insurance cover), the level of transparency, and the value and culture of the fund (AIST, sub. 28, p. 20; ISA, sub. 40, p. 38; REST, sub. 23, p. 8).

The Commission agrees that members' best interests should sit above other model assessment criteria. Hence, it will assess whether the model creates incentives for funds to deliver default products that maximise *member benefits* — defined here as maximising long-term net returns and effectively matching members to products that meet their needs. In the Commission's view, these outcomes are an input into (and consistent with) meeting members' best interests. In assessing this criterion, the Commission will consider the following factors:

- whether the selection and allocation process provides sufficient incentives and discipline on funds to focus on maximising long-term net returns to default members, taking account of risks
- whether members are able to undertake meaningful comparisons across product and service offerings in the market

whether the selection and allocation process provides sufficient incentives and
discipline on funds to provide products which incorporate services (such as call centres,
online resources, and intrafund advice) that provide a minimum level of service quality,
but do not add unnecessary costs that may detract from net returns. Chapter 3 provides
further examples and guidance on what the Commission considers to be a minimum
level of service quality.

# **Criterion 2: Competition**

Does the model encourage open participation (contestability) and rivalry between funds (competition) that drives innovation, cost reductions and more efficient long-term outcomes for members?

Competition may offer benefits beyond long-term net returns and members being allocated to products which meet their needs. It is potentially a powerful tool to drive efficiency in the superannuation system over time, including by providing incentives for funds to lower their costs, improve their service quality and innovate. However, competition may not always promote more efficient long-term outcomes for members, and can be promoted in different ways (chapter 1).

This leaves the question of how competition is factored into an assessment of new alternative models. This was a source of debate among inquiry participants. Several participants expressed concern that including competition as a standalone criterion gave it too much prominence, and confuses means with ends. The potential for competition to lead to adverse outcomes for default members was raised, and if competition was retained as a criterion, a common view was that it should be subservient to criteria focused on efficiency or members' best interests (for example, AIST, sub. 28, pp. 20–21; ISA, sub. 40).

Other participants supported competition as a standalone criterion. For example, FSC (sub. 38, p. 7) suggested that competition should be one of the primary criterion used, while Kinetic Superannuation (sub. 45, p. 2) submitted that competition drives cost reductions and encourages innovation which in turn leads to long-run improvements in efficiency. Some participants noted that barriers prevent certain funds from competing for default members in the current system (for example, FSC, sub. 38, p. 31), and that a new alternative model's impact on competition should focus on the number and severity of barriers to entry and exit in the market (for example, FPA, sub. 29, p. 3).

Probably the best way to consider whether competition is a relevant criterion is to consider a system for default provision that offers none. In such a circumstance, reliance would have to be made on actions from outside the super system to offer dynamic efficiency improvements. It might be possible to envisage such a system *at a point in time* maximising member benefits by a combination of well-informed benign intervention and well-intentioned management. But over time and with many providers, variation in performance by both regulator and manager is inevitable and experience suggests neither are sustainable at such an exceptional level without an incentive to adapt to better ideas or

new needs. Competition provides an incentive to address such opportunities and needs; and the degree to which it is present determines the timing and spread of such actions. Innovation delayed is clearly a cost to members.

The Commission nevertheless agrees that competition in the superannuation system is an intermediate objective insofar as it drives improved outcomes for members: lower prices, better products, and improved choices. It will be important to identify the likelihood and materiality of the potential risks and rewards of greater competition. That said, the need to balance competition with other considerations is not unique to the superannuation sector — for example, various provisions within industry-specific and general competition law provide scope to balance and weigh the impacts of policy changes on competition, efficiency and community-wide interests. <sup>10</sup>

In summary, the Commission considers that it is relevant to retain competition as one of the five assessment criteria. In assessing the merits of each model, the Commission will assess the extent to which it can harness the benefits of open participation (contestability) and rivalry between funds (competition) to drive innovation, cost reductions, and improved long-term outcomes for members — this will feed directly into an assessment of members' best interests. More specifically, the Commission will consider the following factors:

- the type of competition that the model seeks to inject into the process for allocating default members to products (that is, whether it creates 'competition in the market' or 'competition for the market', or both) (chapter 1)
- the extent to which the model enables the efficient entry and exit of funds, and provides funds with an equal opportunity to be assessed as a default provider (provided they meet the necessary minimum standards)
- whether the model provides incentives for funds to develop more innovative products and services over time (which meet default members' needs) and reduce their costs with a strong focus on benefits to their members
- whether the model is likely to require or motivate funds to provide meaningful and comparable information to enable members to make well-informed decisions and undertake meaningful comparisons across product and service offerings in the market
- the extent to which there are likely to be spillover benefits or costs in terms of the
  products and services provided to existing default and non-default members in the
  system.

In its assessment, the Commission will remain mindful of potential trade-offs between competition and other criteria, such as member benefits and system stability.

<sup>&</sup>lt;sup>10</sup> For example, Part VII and Part XIC of the Competition and Consumer Act 2010 (Cwlth).

### Criterion 3: Integrity

Does the model promote a high-degree of integrity in the selection and delivery of default superannuation products, and the ongoing behaviour of superannuation funds more broadly?

Members' best interests are likely to be promoted by a default system which has and promotes a high degree of integrity among its participants. A new alternative model for allocating default members will invariably involve some form of filtering or selection process (even if it is minimal or involves 'nudges'). On the supplier side, funds participating in any process will have more information about their products, services and future intentions than the agent responsible for filtering or selecting products and members. This introduces the risk that commitments by funds during the selection or filtering process do not materialise later. Given the significance of the default sector, the risk that funds could seek to coordinate their behaviour to manage (or game) the process needs to be considered. Some models may be more prone to these risks than others. These risks would work against the best interests of members.

Defaults involve someone else (for example, a fund, employer or another agent) choosing a superannuation product on behalf of an employee, which can introduce 'principal-agent' problems. The integrity of the decision maker involved in this process is therefore an important consideration. Qualities such as relevant expertise and capabilities, understanding members' perspective and needs, freedom from conflicts of interest, transparency and accountability would add to the integrity of the process, while issues such as poorly managed conflicts of interest or a decision maker being captured by the supplier industry would erode it (CIFR, sub. 7, p. 4; ISA, sub. 40, p. 39).

A criterion focused on integrity was broadly supported by inquiry participants (for example Ai Group, sub. 21, p. 3; FPA, sub. 29, p. 3), although views differed on the specific matters to be taken into account. At the selection stage, risks associated with: a lack of knowledge and skill (CIFR, sub. 7, p. 4); regulatory capture (ISA, sub. 40, p. 39); conflicts of interest (ISA, sub. 40, p. 39); political influence (FSC, sub. 38, p. 24); and a lack of transparency and accountability (CIFR, sub. 7, p. 4) were highlighted. In the delivery stage, a consistent theme was that any model would need to have appropriate transparency, governance and accountability mechanisms in place to ensure default providers are held to account for their commitments (AIST, sub. 28, p. 21; Kinetic Superannuation, sub. 45, p. 2) and compliance with legal obligations, such as the Superannuation Guarantee (AustralianSuper, sub. 19, p. 3).

However, participants also delivered words of caution. The FSC (sub. 38, p. 17) suggested that the integrity criterion proposed in the Commission's issues paper seemed inappropriately designed to only consider auction metrics. Other participants warned against over-engineering the regulatory arrangements that would underpin any new alternative model given that strict governance arrangements are already in place to govern fund activities in the superannuation system (for example, Kinetic Superannuation, sub. 45,

pp. 2–4; REST, sub. 23, p. 13); although such responsibilities self-evidently do not extend beyond an individual fund.

In its assessment of new alternative models, the Commission will consider whether each one promotes a high degree of integrity in the selection, filtering, allocation and delivery process. A lack of integrity in these areas could affect confidence in the system more generally. More specifically, the Commission will consider the following factors:

- whether agents responsible for making decisions about default products have appropriate incentives, relevant expertise and capabilities, and whether conflicts can be effectively disclosed and managed
- the extent to which the selection process is transparent and consistent with any pre-process guidance that is in place
- whether and how funds are held to account for commitments they make during the process
- the extent to which the model provides incentives for participating funds and other third parties involved in the process (such as employers and advisers) to act in good faith and in the best interests of all their members (current and prospective)
- the extent to which the model incorporates new regulations to address integrity risks
- the extent to which the model exacerbates peer risk in the system (PC 2016). (Peer risk may also be a factor considered in the context of assessing member benefits and system stability depending on the model being assessed.)

The Commission recognises there is a potential trade-off between introducing new measures to promote integrity under a new alternative model and the additional costs of regulation (which could flow back through to members as higher fees) and costs of administration on government. The system-wide costs criterion will take into account the costs of additional regulation.

# **Criterion 4: Stability**

Is the model likely to create instability in the superannuation system that leads to significant systemic risks?

The stability of the superannuation system was identified as a core objective in the Commission's study to develop criteria for assessing the efficiency and competitiveness of the system (PC 2016). Given the system is growing in size, and is linked to the financial system and the real economy through a multitude of channels, there is potential for systemic risks to move across the system. The default segment represents a large component of the system — for example, total assets in MySuper products (a proxy for the size of the default segment) were \$474 billion as at June 2016, 23 per cent of the about \$2 trillion in the superannuation system (APRA 2017c, pp. 11, 24), and importantly, about two-thirds of fund members (chapter 1).

There was broad support for inclusion of a criterion focused on system stability (for example, Ai Group, sub. 21, p. 3; APRA, sub. 33, p. 1; ISA, sub. 40, p. 39), and regard to whether a model promotes or detracts from system stability (Kinetic Superannuation, sub. 45, p. 6). The need to consider stability from the perspective of members, employers and the broader community (including government) was raised (AIST, sub. 28, p. 22; REST, sub. 23, p. 13). From members' perspective, the stability of the system was seen as a means of fostering confidence and trust in APRA-regulated funds. From funds' perspective, greater certainty of net cash flows provides them with scope to take a long-term approach to investment (AIST, sub. 28, p. 22; ISA, sub. 40, p. 39).

A stable superannuation system that supports efficient outcomes will not be one without change. Some concerns raised by inquiry participants about the impact of new alternative models on stability go to realities that are synonymous with the cut and thrust of any genuinely competitive and dynamic market environment — such as movements in market share for individual firms or inefficient firms exiting or being taken over. And the continuing opportunities for further exploiting economies of scale apparent in superannuation should not be impeded by confusing the number of funds with system stability. These are not systemic risks to the system more broadly. Further, while additional regulation is also often argued as a factor creating uncertainty and working against system stability, well-designed changes to the regulatory environment can promote as much as reduce system stability.

In summary, the Commission does not see churn per se, and the exit (or takeover) of funds, as a sign of stability concerns. Indeed, churn and the exit of underperforming funds is often a sign of healthy competition that should deliver better long-term net returns. Nonetheless, chapter 3 will consider how the design of new allocation models could influence the structure of the market within which funds operate and the incentives for mergers between funds.

In assessing this criterion, the Commission will focus on problems or risks arising which have the *potential* to develop into significant systemic problems. For example, it will be relevant to consider whether any of the models are likely to cause (APRA, sub. 33, pp. 2–3; ASFA, sub. 24, p. 3):

- excessive and volatile movement of members and assets between funds, thereby exacerbating liquidity risk and peer risk in the system
- funds to adopt unsustainable loss leading strategies that could cause broader and significant system disruption in a later period
- excessive market concentration and interconnectedness between upstream service providers and funds in the system that significantly reduces rivalry in the market.

This criterion is framed as a 'negative test' — in other words, is a new alternative model likely to compromise stability? The Commission will consider the extent to which a model may create systemic instability based on the factors listed above.

#### **Criterion 5: System-wide costs**

Does the model minimise overall system-wide costs, taking into account costs on members, employers, funds and governments?

A new alternative model has the potential to introduce costs into the system (such as new administration, marketing, regulatory or compliance, transaction or search costs) and will likely change the costs of participation and their incidence. However, it may also reduce costs in other areas, such as lower search costs for members or a lower burden associated with raising taxes to fund the Age Pension over the long term (as a result of members being in higher performing products). In considering the merits of new alternative models, it is relevant to consider *who* bears increased or reduced costs, and the overall impact on system-wide costs (in other terms, the incremental economic cost impact on the community compared to the baseline).

There is potential for an alternative model to result in transfers between parties. For example, a model based on employer choice would elevate costs to employers while reducing the costs to members who will expend less resources in searching for products and could be guided to a better outcome. A new alternative model may also add to a party's costs in one area but reduce costs in another. For example, a model that involves a selection process would add to funds' costs (as they devote resources to participating) but could save them money on future marketing expenses if they are successful in the process.

Inquiry participants recognised the relevance of examining the total system-wide costs of introducing a default model with a view to comparing this feature across models (for example, FPA, sub. 29, p. 3). There was a view that the Commission should take a broad lens in applying this criterion. For example, ISA (sub. 40, p. 39) argued the cost criterion should focus on efficiency, while AIST (sub. 28, p. 22) suggested that the focus should be on net costs across superannuation and retirement income systems. The Ai Group (sub. 21, p. 3) cautioned the Commission not to double-count costs already included in the assessment of net returns, but recommended a focus on costs borne by employers and governments in administering the models.

A model that minimises total system-wide net costs is clearly in the interests of the broader community, and in most cases, members' best interests, however, there may be instances of trade-offs. For example, minimising the resources devoted to a filtering or selection process may be consistent with minimising total system-wide net costs, but may come at the expense of integrity in the selection and delivery phase.

In its assessment of each new alternative model, the Commission will examine the impact that the introduction of the model would have on costs borne by parties within the system overall. The balance of these impacts will be difficult to discern with precision and will require judgment, which will be informed by the available evidence and feedback from participants. The Commission will not be attempting to calculate the dollar cost of different models. The focus of the qualitative assessment will be on the following factors:

- what is the likely costs impact on members, funds, employers and government, and the materiality of any changes from the baseline?
- is the model likely to lead to overall higher or lower system-wide costs compared to the baseline? What is the expected materiality of any changes from the baseline?

In considering this criterion, the Commission will consider the impact of cost transfers between parties, the potential for costs to be passed through to other parties, and will avoid double counting benefits or costs from a system perspective. For example, a model that results in better member outcomes may reduce government spending on the Age Pension (compared to the baseline), but some component of these cost savings will be reflected in increased member benefits.

Some participants suggested the Commission should take into account the risks and costs associated with transitioning to an alternative model from the current system (for example, AIST, sub. 28, p. 5). As the Commission is not comparing these models to the current system, these types of transition costs are not relevant to this study, although it is expected that they will be an important consideration in stage 3.

# 2.3 The no defaults baseline is not a model

The assessment of new alternative models requires a common reference point for comparison. In its issues paper, the Commission proposed a baseline of no default arrangements. This proposal elicited a substantial amount of participant feedback.

Some participants indicated that the Commission's 'greenfields' approach of no defaults is a reasonable reference point of comparison for new alternative models (CSA, sub. 35, p. 4; PwC, sub. 12, p. 3). However, most participants were critical of a no defaults baseline. Broadly, criticisms fell into two categories:

- a no default baseline should not be the Commission's preferred model as it would not meet members' best interests (for example AustralianSuper, sub. 19, p. 1; First State Super, sub. 26, p. 2; IFAA, sub. 13, p. 6), at least in the short term (FSC, sub. 38, p. 3)
- a no default baseline lacks analytical rigour, it will be difficult (if not impossible) to operationalise in a meaningful way given there is no real-world evidence to assess it, and it could yield misleading results (for example, AIST, sub. 28, p. 13; ISA, sub. 40, pp. 8–9).

Several participants argued that it would be more appropriate to use the current default arrangements as the basis for comparison (for example, ACTU, sub. 34, p. 6; AIST, sub. 28, p. 4; ASFA, sub. 24, p. 2; ISA, sub. 40, p. 9; UniSuper, sub. 20, p. 3).

The Commission's intended application of the no defaults baseline in the context of this inquiry appears to have been misunderstood by some participants. The Commission adopted the baseline as the only objective and feasible reference point against which to

assess new alternative models. Use of this baseline will ensure that the models examined do not merely offer benefits (or costs) above those of the present system but instead actually address what a default system should be aimed at delivering *today*, after nearly 25 years' experience with a major compulsory allocation system of increasing complexity and significance. The absence of any system is a logical way of exposing what would be lost without defaults; and allows consideration of why that is important and whether there are other ways (for example, outside the system itself) to address that.

Moreover, use of a no defaults baseline exhibits a refreshing absence of ideological preference and is about as objective a benchmark as possible. Finally, as a baseline aimed at solving today's problems, it is substantially more oriented towards the future than a baseline that represents the combined best past efforts (wise or foolish) to address past problems and perceptions. Thus the no defaults baseline is not a new alternative model, although at times the Commission will test it in order to see if an apparent problem it creates is substantive or not.

In stage 3 of the Commission's work on superannuation, the present system can be considered against potential new alternative models, and indeed against the Commission's objective baseline. But it will be its ability to deliver on today and future needs that will matter.

Applying a no defaults baseline is not without challenges. Inquiry participants raised valid criticisms and questions on how it would be meaningfully applied to inform the evaluation of new alternative models, and what evidence would be drawn on given it is a hypothetical scenario (for example, AIST, sub. 28, p. 13; ISA, sub. 40, pp. 8–9). Of course this problem of hypotheticals applies to all options (including the untested expert panel process within the FWC), other than advocacy for the incumbent system.

The Commission accepts that in order to apply the baseline of no defaults it needs to provide further explanation on how it will be incorporated into the evaluation of new alternative models. As such, chapter 4 provides a detailed explanation of the evidence and assumptions the Commission has used to inform the baseline of no defaults.

# 3 Approach to developing alternative models

#### **Key points**

- In developing its models, the Commission sought to design a workable system for the future, and in doing so, overcome some of the legacy problems affecting the system today.
- This report presents four alternative models: assisted employee choice, assisted employee choice (with employee protections), a multi-criteria tender, and a fee-based auction.
- The current system is plagued by the issue of members holding multiple accounts. This is largely a product of current policy settings, whereby members are automatically allocated a new default account every time they change jobs and do not exercise choice. Account duplication erodes member balances and imposes costs on other system participants.
- The Commission in principle supports a recommendation by the Financial System Inquiry
  that employees should be allocated to a default product only once upon first entering the
  workforce and retain this account for future jobs unless they choose to switch.
  - While this would be a smaller pool of defaulting members (some 400 000 members each year) to be allocated under the Commission's models, it may prove relatively attractive to some funds and not others.
- A fund that wins default status for contributions of new members should be required to offer the revised winning fees and service terms to all current members of its default product. This would diffuse the benefits of competition to the broader system.
- The default product should focus on the accumulation stage and consist of services that are the minimum necessary to meet the objective for the superannuation system. The bundle should include investment, administration of member accounts and intrafund advice.
  - The bundled insurance product would not be considered in the selection of products.
     Funds would be assessed on their nominated accumulation product, subject to meeting a threshold level of service for bundled insurance.
- The body responsible for selecting eligible default products must have an explicit focus on member interests and be accountable for its decisions. The body must be free of conflicts of interest, display high integrity and have sufficient financial expertise to evaluate products.
- There is strong merit in establishing a centralised online service to assist employees and employers in carrying over existing accounts between jobs, and to inform the Government about member decisions on opening, closing or consolidating their accounts.
  - The ATO is well placed to undertake this task, as it has to issue a Tax File Number to new entrants to the workforce, and operates the Single Touch Payroll system.
- There is merit in immediately establishing a clear, transparent and accountable framework
  to guide trustees when proposing or considering mergers. A key element would be an
  obligation to disclose all mergers considered involving their fund, as well as the reasons for
  the ultimate outcome.

This chapter sets out the framework and some common foundations for developing the alternative models presented in subsequent chapters. Section 3.1 outlines the Commission's approach to specifying those alternative models. Section 3.2 details which employees would be covered by the allocation models. Section 3.3 draws on international experience and past Commission work to identify broad features of the default product at the centre of the allocation models. Finally, section 3.4 identifies other common features of the allocation models, such as the frequency of the process and the characteristics of the body responsible for making the final decisions.

## 3.1 Specifying alternative models for evaluation

The issues paper for this inquiry identified several steps for developing an allocation model and set out the spectrum of options for most of those steps. At a high level, the models differ on two aspects:

- the type of selection mechanism for default products
- the mechanism and decision maker for allocating members to those products.

However, there is a broad range of options within those variables and evaluating every possible model permutation is neither tractable nor necessary. For ease of analysis, the Commission has formulated a discrete set of model types for assessment.

#### How did the Commission select its alternative models?

In narrowing the focus to specific model types, the Commission was guided by several principles. First, as required by its terms of reference, the models had to fit the description of an alternative model — that is, they needed to be different from the current arrangements and from each other. Second, the models had to be comprehensive in covering the options across the spectrum of the Commission's framework. When the models are taken in combination, no design element from the framework is left unexplored. Third, as discussed in chapter 2, the models needed to be workable and consistent with the terms of reference. To determine whether a hypothetical model would be workable, the Commission drew on international examples, in addition to analysing Australian institutional settings and market characteristics. Several approaches have been excluded from consideration due to being inconsistent with the terms of reference or for being manifestly unworkable under the current institutional settings (discussed in the next section). Consequently, this report presents and evaluates four types of allocation models.

- Assisted employee choice this model leverages the competition benefits that arise
  when members exercise choice, but with stronger and formal protections to assist
  members make informed choices.
- Assisted employer choice (with employee protections) this model injects competition by giving employers choice in selecting a default product for their

employees, as long as the default products meet some minimum standards, while also simplifying choices for small and medium-sized businesses.

• A fee-based auction and a multi-criteria tender — these models incorporate a market-based mechanism into the selection of default products, with sequential allocation of members among winning products (figure 3.1).

Figure 3.1 The building blocks for the four allocation models Degree of None Low High Very high filtering Type of Heavy filter Tender Auction None Minimum standards filterina Who **Employee Employer** Government allocates? Assisted Assisted 4 Fee-based 3 Multi-criteria employee employer choice tender auction Baseline choice (with employee protections) Dashed lines indicate where use of filtering is voluntary.

For each of those models the objective was to specify a design that would perform best against the assessment criteria. The Commission took an iterative approach to refining the models based on its own research and analysis, as well as participant feedback. Finally, having specified a 'best-in-class' design for each category, the Commission evaluated the models against the assessment criteria proposed in chapter 2, relative to the baseline of a world of no defaults.

#### System stability was a threshold consideration for model choice and design

As discussed in chapter 2, the Commission interpreted the stability criterion as a threshold consideration for its models. That is, all of the models presented in this report have been designed to avoid generating material risks to the superannuation system.

More specifically, the Commission targeted two types of stability concerns:

- not generating volatile and excessive movement of members and assets between funds
- avoiding unsustainable strategic behaviour by funds.

On the first issue, the key considerations are the size of the pool of default members (both new and existing) to which the models apply, as well as the flow-on implications for other members. A further consideration is how the models accommodate members who are in products that lose default status. Those matters are discussed in this chapter.

The Commission has addressed the second issue through model design — in particular, avoiding excessively frequent repetition of the competitive process (discussed in this chapter) and various safeguards within the models themselves (discussed in chapters 6–8).

Several participants also raised the issue of stability risks to the system from creating an excessively concentrated and interconnected market between funds and upstream suppliers (chapter 2). The Commission was less concerned about its models creating those types of risks. There are too many funds and default products in Australia, many of which are subscale, and some consolidation would be beneficial (APRA, sub. 33). Moreover, other features of the Commission's approach, such as its proposed narrowing of the definition of new default members and regular repetition of the competitive process, safeguard against excessive market concentration.

#### Which models have been excluded from the outset?

#### A single sovereign fund model is not an option for this inquiry

The Commission will not be evaluating models that involve a single or dominant sovereign fund that receives default contributions by fiat. 11 This structure of the pension system is quite common internationally (for example, in France, Sweden, Norway and Japan). Some of these models imply or specify a government guarantee. A government guarantee is not inherent in the Australian system and this is a desirable position to retain. It is also inconsistent with the focus on a competitive process, sought by the terms of reference.

#### The models that focus on the wholesale level of the market will not be considered

In Australia, the superannuation system is characterised by a degree of competition at both the retail and wholesale levels of the market (PC 2016). Funds either insource specific investment and administration services or outsource them to wholesale providers, and then deliver a service bundle (the accumulation product) to the member. In some international systems the competitive process is targeted at the wholesale level. This is typically the case in centralised systems (for example, in Sweden and the United Kingdom), where a single public trustee procures services from a pool of investment managers (appendix B). The US Thrift Savings Plan for federal government employees is another example (box 3.1). A review of the Swedish pension system found that there are cost savings in decoupling administration from investment and centralising the former in the hands of the government (Barr 2013, p. 75). Some participants proposed that the Commission should consider models that involve a government-run competitive process at the wholesale level. This could be done either in combination with a process at the retail level or instead of it, as in the centralised systems referred to above.

<sup>11</sup> This is distinct from a model discussed in chapter 5 that involves a temporary 'last-resort' fund as a protection against members forfeiting their contributions due to failing to nominate a product in the open market.

#### Box 3.1 The US Thrift Savings Plan

As at December 2015, the US Thrift Savings Plan had over US\$458 billion in funds under management. It is available for all federal employees, who are automatically enrolled when they begin work. The default employee contribution rate is 3 per cent of the salary, and employers contribute a further 4 per cent. Employees can opt out at any time, and if they reduce their contribution rate the employer contribution will also fall. Individuals can invest their money in one of five life-cycle funds or manage their own account by choosing an investment mix from five individual funds: a government securities fund, a fixed-income fund, a common stock fund, a small capitalisation fund and an international stock fund.

Funds must be managed passively, and thus the individual funds aim to track specific asset-class indices. Management of four individual funds is tendered for and managed externally (the government securities fund is managed in house). The Thrift Savings Plan uses an internal procurement team to operate this tender process.

Sources: FRTIB (2016); TSF(2015); White (2011).

The Commission has decided not to assess such a concept at this stage of the inquiry. <sup>12</sup> The explicit focus of this inquiry is to inject competitive pressure at the trustee (retail) level. It is at this level where, despite the existence of some member choice, there are fundamental challenges for members to make an informed and rational decision (chapter 1). Centralised tendering for wholesale services targets competition in the wholesale market (investment and administration services), which does not have the same issues of disengagement on the demand side. Researchers have argued that trustees already place strong pressure on service providers. For example, Chant West (2015, p. 1) stated:

We contend that, while consumers (i.e. fund members) are not driving competition, the funds themselves and their service providers are. Every day, in the course of our business, we observe funds and providers competing fiercely, and we believe this ensures competitive pricing.

The remainder of the chapter specifies some common foundations for the models considered in this report. In particular, it describes the market that is at the centre of all of the models, from the perspective of members and providers. In looking at the relevant variables the Commission has examined selected features of default private pension systems in other countries (table 3.1).

<sup>12</sup> That said, the Commission may still revisit particular aspects of the Swedish and US Thrift models in the context of its stage 3 inquiry.

Table 3.1	Selected features of international default systems <sup>a</sup>							
	Australia	New Zealand	United States	United Kingdom	Sweden	Chile	Canada	
Compulsory?	Yes	No (opt out)	No (opt out)	No (opt out)	Yes	Yes	Yes	
Life stages	Accumulation	Accumulation	Accumulation <b>b</b>	Accumulation	All	Accumulation	All	
Scope of coverage	Universal, segmented by modern award	Universal, subject to some restrictions	Universal eligibility, segmented by employer	Universal, subject to some restrictions	Universal	Universal	Universal, subject to some restrictions	
Definition of new default member	New job and not exercising choice	First job and no active employee or employer choice	Automatic enrolment by employer	New job and not exercising choice	First job and not exercising choice	First job	First job; employees have no choice	
Market structure and service provision model	Employer chooses fund as default provider of the bundle of services for its employees; funds insource or outsource services	Employees sequentially allocated to an eligible fund that provides a bundle of services; funds insource or outsource services	Employer chooses fund as default provider of the bundle of services for its employees; funds insource or outsource services	Employers choose public trustee as default provider of service bundle; public trustee procures services from private sector	Single product provided by public agency; in-house administration and mix of insourcing and outsourcing of investment	Single default provider (winner of a tender) offering a bundle of insourced or outsourced services to employees	Single product provided by public agency; in-house administration, and investment by independent statutory board	
Services bundled in default	Administration, investment, intrafund advice, life and TPD <sup>c</sup> insurance	Administration, investment, member education	Administration, investment; can include employee advice and education	Administration, investment, intrafund advice	Administration, investment, intrafund advice, pension	Administration, investment, intrafund advice, life and TPD <sup>c</sup> insurance	Administration, investment, intrafund advice, life and TPD <sup>c</sup> insurance, pension	
Centralised administration?	Largely decentralised	Centralised clearing house	Largely decentralised	Centralised	Centralised	Decentralised	Centralised	
Prescribed	No prescription;	Mandatory low risk	No prescription for	Single target date	Passive or active	Passive investment;	Passive and active	

option for members investment; single

option for members

(life-cycle)

five risk-based

investment options

investment over long

term; largely defined

benefit for members

portfolio; single option employers; single

option for members

for members

investment

approach?

single option for

or diversified)

members (life-cycle

<sup>&</sup>lt;sup>a</sup> The international systems covered in the table are the NZ KiwiSaver, the US 401(k) auto-enrolment, the UK NEST, the Swedish AP7, the Chilean default AFP, and the Canada Pension Plan. <sup>b</sup> Retirement income products are not directly provided by 401(k) providers but can be purchased by them for their members. <sup>c</sup> Total and permanent disability. Sources: Appendix B (for Chile, NZ, Sweden, UK systems); IRS (2017); US DOL and IRS (2013); CP Investment Board (2016); Government of Canada (2016).

## 3.2 Which employees will the models cover?

A fundamental design consideration, which is common to all models, is what employees they will ultimately cover and how.

### **Employee choice would remain**

The Commission has adopted the definition of 'default products' as products to which employees are allocated *if they fail to exercise their right to choose a product*. None of the models presented in this report mandate that employees join or remain with a particular default product and it is envisaged that employees will have the right to choose their own product, and switch products after joining.

This interpretation is largely consistent with the Choice of Fund requirements legislated by the Australian Government, notwithstanding some constraints on the coverage of those provisions (discussed below). It is also consistent with international practice, and generally accepted by industry participants in Australia, despite some disagreement on the merits of active member choice. Beyond that, there are three aspects to the employee coverage issue:

- the models' coverage of the flow of employees specifically, the definition of a new default member and the trigger point for being allocated to the default product
- whether and how the models should apply to the stock of existing default members
- the institutional constraints on the application of the models to some members.

#### Who is a 'new default member'?

Under the current arrangements, an employee typically acquires a default product when they enter the workforce for the first time, and thereafter would get a new account every time they change jobs and do not actively choose a product. The current defaulting structure leads to unnecessary account proliferation and erosion of member balances.

This structure is a historical consequence of the origins of superannuation in industrial relations traditional defined benefit schemes. It is essentially an outcome of not providing adequate infrastructure to support individuals following the introduction of a compulsory defined contribution system. The purpose of this inquiry is to design allocation models for the future, and this includes revisiting legacy policies that might no longer be in the best interests of members. In this context, the Financial System Inquiry (FSI) (Murray et al. 2014) recommended that employees should be allocated to a default product only once — typically when they first join the workforce — and should subsequently retain that account unless they choose a different fund. The Commission has conducted a preliminary assessment of this proposal.

#### Evaluating the merits of the proposed definition of a new default member

Account proliferation is a significant issue, notwithstanding some recent evidence of consolidation activity. <sup>13</sup> Available data for 2015 indicate that there were 2.2 accounts for each member of the system. Well over 40 per cent of members retain multiple accounts (ATO, pers. comm., 29 September 2016; 2016c) There is also evidence of members holding duplicate insurance (PC 2016, p. 150).

#### Costs of account proliferation

Some members would hold multiple accounts deliberately for various reasons (for example, retaining an account in a corporate fund or a defined benefit scheme). But the majority likely have multiple accounts due to the operation of the current default system that potentially triggers the creation of a new default account with every change of job. Multiple accounts are a source of significant inefficiency in the system. Account proliferation erodes economies of scale in member administration and reduces member balances through duplicated provision of services. And duplicate insurance policies (particularly where the member can only claim under one policy) are a source of inefficiency in their own right. Account proliferation is also likely to be regressive and have the greatest effect on those who are least well off. Employees that work multiple part-time or casual jobs and in the course of their lives have acquired a large number of accounts with low balances in each would be particularly affected by paying the fixed costs of maintaining those accounts.

The Australian Chamber of Commerce and Industry (sub. 27, p. 11) argued:

If it is accepted that account proliferation across and within funds is systemically undesirable, any replacement default allocation mechanism should not operate to allocate a default fund for an eligible employee with each new job. This suggests that, in principle and subject to the employee exercising choice at any time, an eligible employee should bring his or her allocated fund into his or her second and subsequent jobs.

There are significant gaps in the data that preclude an accurate estimate of 'unintended' account proliferation (box 3.2). These data gaps are a policy problem in their own right, and warrant attention by the Australian Government (discussed in section 3.4). However, in all likelihood the benefit from reducing the proliferation of member accounts and duplication of costs charged to members is significant. For example, the Grattan Institute (Minifie, Cameron and Savage 2015) estimated that removing about 12 million excess accounts from the system would save about \$360 million in administration costs per year. The FSI (Murray et al. 2014, p. 110) estimated that moving from an average of 2.5 accounts to a single account over a person's working life could increase superannuation balances by about \$25 000.

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<sup>13</sup> For example, between 1 July 2013 and 1 January 2017 about 1.4 million accounts with an aggregate value of about \$6.8 billion were consolidated through the Australian Taxation Office's online system (ATO, pers. comm., 28 February 2017).

#### Box 3.2 **Estimating account proliferation — the data gaps**

Several agencies collect a large volume of superannuation-related data from funds, employers and employees. However, there are material gaps in the data that relate to member decisions with respect to their accounts as well as the types of products they are in. This precludes an accurate estimate of how many accounts have been opened unintentionally and are surplus to member requirements.

Specifically, the Australian Prudential Regulation Authority (APRA) collects data on the stock and flow of accounts within APRA-regulated funds by product type (choice or MySuper), but there is no ready way to link this information to particular members across funds. For example, the data would not allow a precise estimate of the overall number of members with MySuper accounts in any given year and, consequently, a precise estimate of account proliferation in MySuper.

The Australian Taxation Office (ATO) collects data on the number of members that open new accounts, and on the number of accounts they open and hold. However, it does not collect data on the types of accounts held by members, nor on whether those accounts were selected by active choice or through default. There is also no way to attribute the reasons for members opening new accounts, nor a comprehensive record of whether existing balances were consolidated into a newly opened account.

For its estimate of the number of accounts opened under the first-timer scenario, the Commission has relied on ATO data on the number of members that open their first ever account every year. Data limitations have prevented the Commission from estimating the number of accounts added to the system unnecessarily under the current job turnover defaulting arrangements. Thus, the estimate of the benefit from reducing account proliferation due to moving to the first-timer approach is only intended to be indicative.

Based on the Commission's indicative estimates, the annual system-wide savings in administrative fees and insurance premiums from moving to a first-timer default could be of the order of \$150 million for every 500 000 to 600 000 of default accounts permanently removed from the system (see the annex to this chapter). There would also be time saved by members who would need to manage fewer accounts. Furthermore, this approach could mitigate 'system leakages' in the form of lost member accounts — an ongoing issue in the superannuation system, despite significant recent work by the Australian Taxation Office (ATO) to reconnect members with lost accounts (PC 2016, pp. 296–297).

#### **DRAFT FINDING 3.1**

The current arrangements where members can be defaulted to a new account on every change of jobs increase the proliferation of accounts. This materially adds to costs for members and reduces member balances at retirement.

#### The effect of the FSI approach on the incentives of funds to participate

Notwithstanding those benefits, there are implications for a competitive model in moving from the current 'job turnover' pool of new default members to the FSI's approach of only

targeting those who are first entering the workforce. What will ultimately matter is whether the pool size would be sufficiently attractive to induce funds to participate in a competitive process and offer additional benefits for members.

A preliminary estimate of the *initial* value of the first-timer pool is about \$800 million per annum (annex). In the short run, this value is substantially lower than that of the current turnover pool. This is because the turnover pool comprises more people who are on higher incomes than first entrants into the workforce, and because some of those people consolidate their existing balances into the new account. The value of the first-timer pool is also relatively small in the context of the aggregate flow of default contributions, which amounted to \$74 billion in 2016 (APRA 2017b). Large funds that would have to offer all their current default members the flow-on of a successful bid (discussed below) might not find it attractive to offer any improvements over their current default products.

However, the value of the first-timer pool of contributions is certainly not immaterial, particularly when the contributions of each cohort are examined over the medium term. A key reason for the initial small size of the pool is that the average income of members is about \$21 000 (which reflects the part-time or casual nature of the first job). Contributions from each year's first-timer cohort would grow strongly in the short term as those members catch up to average incomes, and those members would be likely to remain in their original default product for extended periods because there would be no automatic switching of default products on changing jobs. Applying the average income of the turnover group to the first-timer cohort yields a pool of annual contributions of over \$2 billion per year. This is on par with, or greater than the gross inflow of contributions for all but the largest 10 MySuper products in 2016 (table 3.2). The pool of young long-term members (figure 3.4 in annex) is even more attractive in the context of the ageing member bases of many funds and the net flow of contributions into default products. In 2016, only five MySuper products registered net flows above \$2 billion. Nearly 80 APRA-regulated funds accounting for almost a quarter of the assets in all APRA funds — recorded a net outflow in 2016 (APRA 2017a).

Furthermore, attaining default status would also generate some flow-on 'signalling' benefits for the fund from being able to market to (and attract) some members outside of the narrower definition of new default members.

Ultimately, moving to a first-timer definition of new default members is unlikely to adversely affect competition between funds for that pool of members. Competition is not solely contingent on participation by the largest funds, nor does it require the involvement of many funds.

Table 3.2 MySuper assets and flows of the largest MySuper funds, 2016<sup>a</sup>

	Average MySuper assets	Average MySuper contributions	Average MySuper net flows
	\$b	\$b	\$b
Top 5 funds	32.9	5.1	2.5
Funds ranked 6-10	21.0	2.9	1.9
Funds ranked 16-20	7.0	1.2	0.7

<sup>&</sup>lt;sup>a</sup> Funds are ranked on the level of gross MySuper contributions, not net flows or assets. Source: Productivity Commission estimates based on APRA (2017a).

#### **INFORMATION REQUEST 3.1**

The Commission is seeking comment from the industry on the effect on fund participation in the competitive process of moving to the first-timer pool of default members.

- Are there any funds that might choose not to participate due to the lower value of the pool, and what is the threshold minimum pool size (per fund) at which this might happen?
- How would the move to a first-timer pool of default members affect the fees and product features that funds would offer when competing for new members?

#### Other implications for efficiency

Adopting a first-timer definition for new default members could have other implications for efficiency, although none of these appear insurmountable and most would be transitory.

As the target group of employees who would be the direct beneficiaries of the competitive process is smaller, there is a risk that the gains from the competitive process would not diffuse as quickly or as broadly within the superannuation system. However, to some extent this should be addressed by a requirement that successful funds extend the same fees and product terms to their existing default members (discussed below). Also, as noted above, there would be some people who switch into the successful products voluntarily, as funds market those products more broadly.

There may also be potential adverse effects for employees who, in the absence of other actions would remain in their default fund for many years. Under the current arrangements, being asked to select a product on changing jobs is an opportunity for employees to review the suitability and performance of their existing superannuation product. However, retaining the existing turnover default arrangements is an indirect way of encouraging members to engage with their superannuation, and current evidence indicates that members rarely review their product when changing jobs, in any case.

#### **DRAFT RECOMMENDATION 3.1**

To avoid perpetuating the legacy problems of the current system, any future alternative system for allocating members to default products should be premised on employees being assigned a default product only once, when they join the workforce.

#### The need for additional infrastructure to support employees and employers

Additional infrastructure is needed to immediately address account proliferation and critical data gaps. It would also be needed to facilitate the effective operation of the alternative default arrangements. From an employer's perspective, having access to an online service that identifies the fund and account details of employees that already have an account would simplify compliance with Superannuation Guarantee obligations and reduce the risk of opening additional accounts. For employees, a service that simplifies the carryover of their existing accounts when changing jobs would be similarly helpful. As discussed in section 3.4, current and forthcoming initiatives by the ATO could be readily adapted to the task.

## How should the models accommodate existing members?

A well-designed competitive process would be expected to lead to lower fees, higher net returns and other benefits for members. A threshold issue is whether these benefits should apply only to those employees that had been directly defaulted into the product following the competitive process, or extend to other members. For example, in Chile, a fund that wins the fee-based auction for new default members must offer the same fee to its existing default members (appendix B). The Commission considered two options for extending the mechanism to existing members:

- the fees, terms and conditions of the winning product are extended to current members of the fund's default product
- the fees, terms and conditions of the winning products are extended to all existing default members in the system.

#### Accommodating other default members of the winning fund(s)

As discussed above, extending the fees and terms of the winning product to other default members of the fund could discourage participation by funds with a large stock of default members that hold higher-margin products. Nevertheless, there is a strong case to adopt this approach on fairness, simplicity and efficiency grounds. First, as noted, it would accelerate the diffusion of the benefits of the competitive process across the system. Second, it would avoid the problem of creating two classes of default members in a fund, with some being in a superior product through sheer luck of timing. It is also likely to be

more consistent with a trustee's fiduciary duty to act in the best interests of all members. Third, it reduces the risk of unsustainable loss-leading behaviour by funds competing for new default members, simply to grow market share.

Fourth, it is likely to be simpler to administer and navigate for all parties, and would also be consistent with the motivations behind the current MySuper architecture (Cooper et al. 2010). In the absence of a process to consolidate default members within a fund, any allocation model could, over time, result in layers of default products and add to complexity in an already complex system.

To ensure that the flow-on benefits reach the other default members of the fund, the new product terms and fees would need to be extended immediately to everyone in the generic default product of the fund.

## Should default members in other funds be automatically moved to winning products?

There may appear on first glance to be an equity rationale in favour of extending any gains for new default fund members to members in all other default products, regardless of whether their fund won a contest or not. They are, after all, default product members too, who have been guided into their current (now relatively worse) position by the government.

However, on closer examination, there is little merit in automatically moving the entire system's pre-existing default product members to the new winning product/s at the end of each iteration of the selection process. The implications of this are very large and mostly negative. In effect, this would make the product selection process a trigger point for reallocating all default members to new default product(s). The pool for which funds would be competing would be the contributions of all members in default products — over \$74 billion in 2016, and growing (APRA 2017a).

This approach would likely significantly increase member churn with adverse consequences not just for liquidity but for system stability. As noted earlier, the Commission has eschewed options that could adversely affect system stability. The benefits of any lowering of fees or improved service quality would be swept away should such a scenario emerge. The Commission agrees with the Australian Institute of Superannuation Trustees (sub. 28, p. 33), which argued:

Existing members should remain in their fund until they either exercise choice, provided the relevant fund remains entitled to receive default superannuation payments.

Nonetheless, to facilitate broader diffusion of competitive pressure, all of the models need to accommodate *voluntary* switching by members into the successful products. This is consistent with current policy. As a general principle, successful products should be open to members of other funds.

#### **DRAFT FINDING 3.2**

There are strong grounds for requiring a fund that wins default status for contributions of new default members to extend the same fees and service terms to all its existing members of the default product.

## Dealing with members in products that lose default status

A fundamental long-term issue for all allocation models is how they deal with default members of a fund if that fund's product loses default status or is unsuccessful in a future iteration of the competitive process. The question is particularly important where a default member is only allocated to a product once. The issue has not arisen in Australia to date, and no regulatory or policy guidance has been developed yet to clarify the implications for the fund and its existing members if and when it would. <sup>14</sup> There are two interrelated aspects to the question:

- 1. what should happen to the accumulated balances and future contributions of existing default members of the fund?
- 2. if the fund retains its existing default members, should there be any safeguards to protect those members when the fund is no longer bound by its original default contractual or regulatory obligations?

There is a spectrum of options for addressing the first question, with automatic transfer of members to another product being the most far-reaching. In general, to foster system stability, automatic transfer of members should apply only in exceptional circumstances. This would involve situations where a fund is wound up or deregistered as a superannuation entity, or fails to meet mandatory requirements for a default product (as discussed in chapter 8). This would generally be expected to be a rare occurrence.

For situations where a fund is unsuccessful in a future round of the competitive process, the best approach is making this information publicly available, and leaving the decision to members.

With respect to the second question, the key risk is of strategic behaviour by funds seeking to capture a pool of disengaged default members and subsequently raising fees or reducing product quality. The magnitude of this risk with a repeated process over an extended timeframe is unclear. As discussed in chapters 6–8, to some extent it could be addressed through fund selection criteria (for example, focusing on past history of performance and member satisfaction) and other features of the allocation model. However, it is challenging to eliminate the risk entirely. It is neither practical nor desirable to require funds to commit

<sup>14</sup> The Deputy Chairman of APRA has recently indicated that APRA is focusing on ensuring that trustees are proactively considering their strategy, and where necessary, 'planning for a (hopefully graceful) exit from the industry' (Yeates 2015).

to a particular level of fees or product quality in perpetuity. Thus, much of the task would ultimately fall to adequate and well-enforced (ex-post) regulation of trustee duties to act in members' best interests.

In sum, the preferred approach to the above issues would generally avoid automatically transferring members and would focus on transparency and ongoing prudential and consumer protection regulation. The allocation models in subsequent chapters specify particular safeguards in this context.

### Institutional constraints on coverage

The scope of coverage of the current default system is governed by a complex interplay of various Commonwealth and State legislation. At the Commonwealth level, the two key pieces of legislation are the *Superannuation Guarantee (Administration) Act 1992* (Cwlth) (SG Act) and the *Fair Work Act 2009* (Cwlth). The SG Act requires employers to offer choice of fund and provide a default fund, and the Fair Work Act establishes the current process for selecting default funds. The two statutes differ in their general coverage, with the SG Act having broader application. Each of those Acts also provides a range of exemptions.

Specifically, the SG Act is binding on all jurisdictions, but provides exemptions to the choice of fund requirement for:

- situations where an enterprise agreement specifies a fund
- Commonwealth defined benefit schemes, such as PSS and CSS, as well as unfunded public sector schemes
- a number of 'prescribed' State Government schemes (currently 18) for state and local government employees (s. 32C of SG Act).

Not all of those exemptions are an immovable constraint on the Australian Government in implementing a national model for allocating members to superannuation products. For example, there are no apparent constitutional barriers to removing the 'deemed choice' exemption for enterprise agreements. <sup>15</sup> There might be constitutional constraints on extending the model to prescribed and defined benefit State schemes. However, even in those cases, most jurisdictions have voluntarily offered choice to their public servants, <sup>16</sup> and this segment of the system is also generally closed to new members.

On the other hand, the Commission estimated that in 2015, the Fair Work Act covered about 71 per cent of workers (and 85 per cent of employees) (PC 2015b, p. 78). Most State

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<sup>&</sup>lt;sup>15</sup> The Superannuation Legislation Amendment (Choice of Fund) Bill 2016 that sought to achieve this lapsed at prorogation of the 44th Parliament.

<sup>16</sup> For example, the largest schemes for public servants in all states, except Queensland and South Australia, offer choice. QSuper — the largest public sector fund in Queensland — allows members to transfer their benefits to another fund on an annual basis (QSuper 2017).

Governments have not referred the industrial relations powers that govern their public services to the Commonwealth and the national system does not apply to most state and local government employees (table 3.3). The Commission estimated that up to 63 per cent of public sector workers were not covered by the Fair Work Act (PC 2015b, p. 779). The Act also does not cover some private sector workers, such as independent contractors.

Table 3.3	The application of the federal workplace relations system across jurisdictions				
Jurisdiction	Who is covered by the Fair Work Act?	Who is covered by State laws?			
NSW	Private sector employees and employees of constitutional corporations	State public sector workers and local government employees			
Vic	All employees				
Qld	Private sector employees and employees of constitutional corporations	State public sector workers and local government employees			
SA	Private sector employees and employees of constitutional corporations	State public sector workers and local government employees			
WA	Employees of constitutional corporations with some additional areas where employers and employees have other connections with the federal system	All other employees			
Tas	Private sector employees, local government employees and employees of constitutional corporations	State public sector workers			
NT	All employees				
ACT	All employees				
Source: CPSU SPSF Group (sub. 90 to PC 2015b).					

The Commission's approach to the above institutional constraints would be to take them as given where they are a hard Constitutional constraint and relevant to the specific model. At this stage, the Commission does not consider that these constraints will have a material impact on the potential coverage of the alternative models.

## 3.3 Characteristics of the default product

## Coverage of life-cycle phases

Consistent with the terms of reference, the primary focus of this inquiry has been to design a model for the accumulation phase of the member's life-cycle. The Commission has also considered the merits of incorporating the retirement phase into the models. At present, there are no default arrangements for the retirement phase of superannuation. However, as part of the Australian Government's response to a recommendation by the FSI, the Treasury (2016) is developing a policy framework for a comprehensive income product for retirement. It is envisaged that trustees will develop a 'MyRetirement product' for their members, which will operate as a 'soft default', that is, it will be offered to members on an opt-in basis.

The case for integrating accumulation and retirement phases in a single selection process rests on the objective of designing a model that will remain relevant over time in the face of ongoing ageing of the Australian population. As the proportion of the population in the retirement phases of their lives grows, so would the importance of reflecting the needs of retirees in superannuation policy. There is a further issue of ensuring the ongoing viability and scale of default providers in the context of demographic change. A default allocation model that integrates the accumulation and retirement phases is one way of addressing those issues.

However, there are also compelling arguments against this approach. Notwithstanding a common goal for members across all life stages — the objective to maximise long-term net returns on contributions — there are also material differences between the accumulation and retirement phases (PC 2016). These stem from the distinct characteristics of members (including the extent and quality of their engagement with the system), as well as the nature of the decisions they make and the services they demand. Retirement often brings additional complexity into superannuation decisions. It requires the person to manage their longevity and short-term investment risks in addition to long-term investment risks that are the only factor for most of the accumulation phase. The significant differences between the two phases is an argument for specialisation by providers within each phase.

In Australia, funds have historically been slow to develop retirement income products for their members (PC 2016, appendix D). While this might be partly attributable to immaturity of the system, past regulatory barriers, and potentially a lack of competition, it could also be due to limited scope for efficiency gains from bundling the two types of service within a single provider.

Internationally, the private pension systems most similar to Australia's have a sole focus on accumulation (table 3.1). Those that incorporate retirement (for example, Sweden) are typically centralised systems with a single government provider and mandatory pooling of risk across the entire population. This is a market structure that might better lend itself to 'hard defaults' in the retirement phase of superannuation, both due to administrative savings on the supply side and the pooling of risks on the demand side.

The Commission's view is that the models should focus solely on the factors relevant to the accumulation phase of members. <sup>17</sup> Additional complexity is not likely to illuminate the question of default models at the start of a working life. Stage 3 of this inquiry process may allow for the wider issue of failure to develop pension products to be better exposed.

<sup>17</sup> Some researchers (for example, Drew, Walk and West (2015)) also identify an additional 'transition' stage between accumulation and retirement. There may be a case for providing some generic advice on managing transitional risks in the accumulation stage.

## Specifying the services within the default product

At a high level, the bundle of superannuation services to which default members would be assigned is common to all allocation models considered in this report. This section sets out the broad characteristics of the default product at the core of each model. There are two threshold questions:

- 1. What services should form part of the default product?
- 2. To what extent should the nature of the services in the default product (in particular, investment) be prescriptively specified?

#### What services are part of the default product?

At a high level, the approach to specifying the default product is informed by the Government's stated objective for the superannuation system, which refers to 'providing income in retirement to substitute or supplement the Age Pension'. Beyond that, the Cooper Review (Cooper et al. 2010, p. 11) identified several key features for the current MySuper architecture.

- MySuper products are intended to be simple and cost-effective to service a core demographic of members, the majority of whom have low balances and are disengaged from the system.
- The products should also be suitable for those who actively elect to be in a simple default product.
- The products would have an enhanced focus on maximising net returns and reducing costs, and would have a degree of homogeneity to facilitate comparisons and improve competition on price and performance.

The Commission agrees with this approach, but would emphasise that the needs of default members who are disengaged and do not exercise choice should be the primary factor in specifying the default product. Some engaged members might elect to be in the default product, but this is not the 'core demographic' for it, and default services should not be improved to reflect their needs at the expense of those who are disengaged and may not value those enhancements.

In sum, the guiding principle is that the bundle of services in the default product should be the minimum necessary to meet the Government's stated objective for superannuation. The key services that must be included in any default product are investment, administration of member accounts and intrafund advice. The administrative services and intrafund advice provided to default members should meet a standard that allows members to be reasonably informed about the performance of their investment product, the fees that are associated with it, the intrafund switching options and the process for exiting the fund. The advisory services that would be recoverable through a general administrative fee would also incorporate provision of information about the operation of the superannuation system and general financial advice (for example, online calculators and guides on managing transition

risk prior to retirement). For the most part, those services can be delivered through digital channels (website and online account access) and functional call centre support.

Superannuation funds provide a large range of services, some of which are incidental to the main objectives of the system, including flexible investment options, individual financial advice, and various banking services (figure 3.2). For the most part, those services are offered in the choice segment of the system, and are not needed in a simple default product.

Figure 3.2 Examples of services offered by funds that are not necessary in a default product

#### **Account Flexibility**

- EFT/BPAY Contributions
- Spouse accounts
- Contribution splitting
- Anti-detriment payments
- Linked account fee discounting
- Children's accounts

#### **Investment Flexibility**

- Investment choice
- Multi-manager investment choice
- Online investment switching
- Monthly or quarterly investment reports
- Choice of asset allocation
- Ethical investment choice
- Term deposit investment choice
- Choice of fund managers
- Automatic portfolio rebalancing
- Direct shares investment facility

#### **Ancillary Services**

- Financial advice limited
- Non-super investment products
- Loans (home, credit, personal and business)
- Savings accounts
- Non-super insurance
- Shopping discounts

Source: Productivity Commission analysis of Rainmaker (nd).

Internationally, some default systems mandate the provision of additional services to support members. For example, the NZ KiwiSaver scheme requires default funds to educate members on making appropriate investment choices, and funds have been addressing this in a range of ways, including communication campaigns, seminars and provision of financial advice (appendix B).

The Commission does not support this approach for Australia. While some funds can and do offer investor education to their members (as distinct from educating members about

the system and intrafund financial advice), it is not apparent that they are universally best placed to do so, nor is this service necessary to meet the Government's stated objective for superannuation.

#### Accounting for service quality

The Commission received a large volume of comment from participants in stage 1 of its superannuation work (PC 2016), and for this inquiry, on the importance of service quality and the shortcomings of focusing on fees and net returns at the expense of service quality. However, as discussed above this is largely a debate for the choice segment of the system, where engaged and (ideally) well-informed members can communicate their preferences about the tailoring and flexibility of the accumulation product.

In effect, the preferred approach is that service quality should not be the primary factor in selecting default products under any of the allocation models. Funds should primarily compete on net returns and costs, subject to meeting a threshold quality of service, not on the quality or range of ancillary services *per se*.

The general approach outlined above is consistent with the bulk of international default systems (table 3.1), as well as the sole purpose test for superannuation fund trustees and the structure of MySuper products (with the exception of bundled insurance, which is discussed below).

#### Treatment of bundled insurance

The issues paper proposed that the allocation models will focus on accumulation products, with life and total and permanent disability insurance being allocated through a separate process. Some participants argued that if insurance were to remain bundled with the default accumulation product, a separate allocation process for insurance would not be efficient or practical. Mercer (sub. 15, p. 6) observed:

We are concerned that such an approach would represent a significant and unnecessary burden for industry, have an adverse impact on acceptance conditions and may be unworkable (e.g. we envisage each fund may have to deal with a multitude of insurers).

The Australian Institute of Superannuation Trustees (sub. 28, pp. 34–5) argued:

The allocation of default funds must incorporate a process which facilitates market or occupation segmentation to ensure default funds in each industry or occupation incorporates relevant and cost effective insurance coverage ... It is unclear why it would be desirable, or indeed possible to undertake a separate competitive tender process for insurance without undermining the benefits of group insurance.

The Commission (PC 2016, pp. 75, 149) recently noted the conflicting objectives placed on trustees, the difficulty in articulating a clear purpose for insurance in superannuation, and the efficiency implications (both positive and negative) of bundling insurance with the

accumulation product. It should also be self-evident to funds and their advisers that the Government's stated objective for the superannuation system does not envisage insurance as an essential element of the system. However, this inquiry will not be determining whether insurance should be bundled with the default product. In this respect, the policy settings will be taken as given.

The sole focus at this stage is on allocating members to default superannuation accumulation products, not insurance products. The former requires the decision maker in all models to make very challenging trade-offs, even before insurance is considered. Thus, the allocation models will be evaluated on the quality of their default superannuation products only.

The Commission will assume that trustees choose to bundle default superannuation products with insurance, subject to meeting their fiduciary and legislative obligations relating to insurance, but the models will *not* involve comparing the quality or price of bundled insurance. Ultimately, protecting member interests with respect to bundled insurance is a task for well-specified and adequately enforced regulation that sets out clear rules for minimum product quality standards and level of cover. Kinetic Superannuation (sub. 45, p. 7), for example, argued that there are several existing instruments that already govern trustees, including trustees' insurance covenants and insurance strategy and framework, as well as regulated minimum standards of cover.

#### How prescriptively should the investment strategy of providers be specified?

Default systems around the world differ in the degree of flexibility they allow providers and members in electing an investment strategy (table 3.1). There are differences in the investment approach (mandatory passive or at the discretion of the provider), whether the level of portfolio risk is prescribed for providers, and whether members have any choice in assembling their portfolio.

The optimal approach to investment in the context of private pension systems is a matter of great debate, which is far from settled (PC 2016). Some commentators (for example, CIFR, sub. 7) cautioned against a 'commoditised' approach and argued that member diversity plays a significant role in selecting a sound investment strategy. On the latter point, however, the Commission considers that a commoditised approach is unavoidable in a default product, and it would not necessarily be problematic given the cost savings from a no-frills approach. Ultimately, product customisation (where it is warranted) is the province of the choice segment.

At present, most funds adopt a balanced fund approach for default members, which has a greater exposure to growth assets than many no frills products used overseas for default options. Since the advent of compulsory superannuation 25 years ago, this has generally been a wise choice. In the context of this inquiry, whether and how the investment approach is incorporated into the criteria for selecting products is a matter for specific models, and the issue is discussed in subsequent chapters. In most models, the focus of the

selection criteria is on relative performance, rather than a mandated investment strategy, and this is generally a better approach for selecting well-performing products. However, in the case of the auction model (chapter 6), some prescription of the investment strategy was an unavoidable consequence of model design.

#### **DRAFT FINDING 3.3**

The default product in all models will focus on the accumulation stage and include investment, administration of member accounts and intrafund advice. It will be a simple and low-cost product aimed at the needs of those who are disengaged from the system.

- A bundled insurance product will not be a factor in the selection of products and is best addressed through regulation and regulator oversight.
- Funds will primarily compete on net returns and costs, subject to meeting a threshold quality of service, not on the quality or range of ancillary services per se.

#### 3.4 Other common foundations for the models

Several additional design characteristics are common to all models presented in this report. This section discusses how frequently the competitive process would be repeated and the principles for developing a body that would administer this process.

#### Frequency of the selection process

A key element common to all of the allocation models relates to the frequency of the selection process. There are clear trade-offs in making this decision. Running the process very frequently would:

- raise costs for all participants
- reduce the size of the prize for participating funds and potentially adversely affect participation
- create risks of short-termism in the way funds set their investment strategies
- potentially undermine system stability due to both short-termism and higher churn of default products.

However, running the process very infrequently also creates several risks, including:

- creating a market with high barriers to entry and exit
- lower dynamic efficiency, because the winning funds secure default status for prolonged periods

• higher cost of any errors made by the body that selects the winning products, because its decisions would be locked in for a longer period of time.

Proposals from participants on the optimal frequency of the process generally ranged between two and five years (AIST, sub. 28, p. 39; IPA, sub. 17, p. 8; Mercer, sub 15, p. 3). In its 2012 report, when looking at the issue in the context of default superannuation in modern awards, the Commission concluded that the process should be run no more frequently than once every four years, and no less frequently than once every eight years (PC 2012, p. 26). The Commission considers that this range strikes the right balance for all its models. Nonetheless, there would be merit in running the process more frequently for the first iterations (that is, once every four years), to sort through any teething problems in the selection process, and gradually move to a less frequent process in the future.

#### **DRAFT FINDING 3.4**

The desirable frequency for the selection process is between four and eight years, with the greater frequency best used in the early period.

### Who will be responsible for selecting products — key principles

The Commission received a large volume of comment on the suitability of particular bodies to the task of selecting eligible default products, as well as on the outcomes under the current arrangements. To be clear, this stage of the inquiry is not assessing the current arrangements and will not draw conclusions on the merits of retaining responsibility for selecting default products within the Fair Work Commission.

Beyond that, the characteristics of a body that would perform the task partly depend on the features of the allocation model it would oversee. Nevertheless, several best practice principles apply irrespective of the model. The Commission considers an organisation suited to running the selection process would possess the following characteristics:

- an obligation to act in the best interests of fund members
- an understanding of the needs of default members and how these are best met
- sufficient expertise and knowledge of superannuation and finance
- transparent processes
- procedural fairness (that is, enabling all relevant parties to participate equally)
- be dispassionate and free of conflicts of interest
- be accountable for its decisions and have credibility with members and funds.

In the context of the above principles, the Commission does not support the proposal by the Centre for International Finance and Regulation (sub. 7, pp. 6–7) to vest the function with a special class of private-sector member agents. As argued by several participants (for

example, CMD, sub. 18; AIST, sub. 28; Mercer, sub. 15), there is a strong case for the process being administered by the Australian Government. While this places some of the responsibility for the outcomes on the government, this is necessary to ensure the integrity and credibility of the process. It is also consistent with the fact that the superannuation system, and in particular, defaults, is largely a construct of regulation that compels member contributions. Nonetheless, government administration of the process should not preclude some private-sector participation in an advisory sense. The body responsible for making decisions should be able to draw on expert advice from all sources.

With respect to the suitability of some existing government bodies, the Commission does not support direct involvement of APRA and the Australian Securities and Investments Commission in the final step of selecting *preferred* default products for members. It agrees with APRA (sub. 33, p. 5) and Industry Super Australia (sub. 40, p. 33) that involving the key financial regulators in this decision would create material conflicts of interest between their regulatory functions and the task of picking winners from the regulated entities.

A key focus would be ensuring that those appointed to the decision-making body have both the expertise and independence to perform their functions. The two elements may sometimes conflict — for example, those with the greatest expertise might not be fully independent. To some extent this might be mitigated by not requiring that all members have expertise in superannuation and finance. Rather, they could be accomplished individuals that have expertise in collecting and evaluating evidence and advice, but also being able to see beyond it. Academic and some (not all) judicial fields generate these capabilities.

A significant risk in constituting the body is if the process for selecting its members becomes politicised and genuine independence is replaced with an objective of ensuring that all of the relevant interests — such as employee and employer groups — are represented. As discussed in the Commission's report on workplace relations (PC 2015b, pp. 161–167), the latter is a recipe for partisanship and unresolvable conflicts of interest.

More broadly, the quality and integrity of the process would need to be facilitated through:

- a robust selection process of members of the responsible body, including a process for termination and replacement of appointments
- adequate reporting and oversight of the process and decisions of the body.

Subsequent chapters build on these best-practice principles in the context of specific allocation models. In particular, chapter 8 expands on the desirable features of the appointment process for a body that could apply a heavy administrative filter.

#### **DRAFT FINDING 3.5**

The selection of eligible default products should be administered by a government body, and be subject to strong governance rules. The decision-making body must:

- have a strong focus on fund member interests
- have sufficient expertise to evaluate products
- be independent and free of real or perceived conflicts of interest
- have processes that are transparent and afford procedural fairness
- be accountable for its decisions.

## A centralised online service to assist members and employers and inform the Government

There are currently material and critical gaps in the information available to the Australian Government about members and their choices with respect to opening, closing or consolidating superannuation accounts. There is also a need for additional infrastructure to facilitate the flow of information between employees and employers, and in the process make it easier for employees to carry-over their existing accounts between jobs.

The ATO is currently developing a new online system that will streamline superannuation fund choice and could be customised to assist both employers and employees, as well as fill an information gap for the Government. As part of the Single Touch Payroll reforms, people starting a job with a participating employer would be able to fill out their 'standard choice' form through the myGov website when declaring their Tax File Number (the system is currently intended to be voluntary for employers). The website would show each employee their existing superannuation accounts and give them the option to select one of those to receive contributions from their new employer. Employees would still be able to nominate a different fund or select their employer's default, as at present (ATO 2016b). There is merit in presenting the information on that website in a way that nudges employees away from opening additional accounts. The employee could be presented with three options as outlined in figure 3.3.

This electronic system would be the starting point for a more streamlined choice process. Extending it to all employees would allow them to more easily pick one of their existing products and make their decision in their own time (provided it is within the required timeframe). In time, the system could also be extended to a wholesale integrated payroll service for employers that would remove the need for employees to log into myGov.

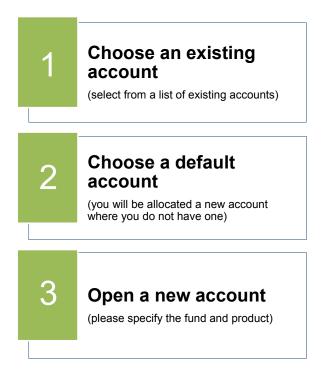
Further customisation of the service for employees could include provision of key information on an employee's existing products to allow them to compare their current product with other options. This was favoured by some inquiry participants (CMD, sub. 18; CHOICE, sub. 31). In a similar vein, the Grattan Institute has proposed

that people also be given this information each time they fill out their tax return (Minifie, Cameron and Savage 2014, p. 30).

Finally, collecting the information submitted by members in a form that enables analysis of system-wide trends in member behaviour with respect to reliance on default allocation, product switching and account consolidation would be useful in informing future government policy.

The Commission will continue consulting with the ATO on the feasibility and design of these online functions. However, its preliminary conclusion is that leveraging off the existing myGov platform is a relatively low cost and credible way of addressing the above objectives.

Figure 3.3 A desirable order of options on an online choice form



#### **DRAFT RECOMMENDATION 3.2**

The Australian Government should establish a centralised online service for members, employers and the Government that builds on existing functionality of myGov and Single Touch Payroll. The service should:

- allow members to register online their choice to open, close or consolidate accounts when they are submitting their Tax File Number on starting a new job
- facilitate the carryover of existing member accounts when members change jobs
- collect information about member choices (including on whether they are electing to open a default account) for their employer and the Government.

There should be universal participation in this process by employees and employers.

#### The case for a central clearing house

A centralised online service described above could be a first step to government provision of a more comprehensive service for employers and employees. The FSI (Murray et al. 2014, p. 116) recommended that 'Government should consider implementing a national 'payment hub' or 'clearing house' by which employers make superannuation contributions to multiple funds'.

Government-run clearing houses that direct the flow of funds from employees, or their employers, to relevant funds are a feature of many private pension systems around the world, including those of New Zealand and Sweden (appendix B). Typically, they have been established to reduce administration costs for employers and funds. In New Zealand, the central clearing house run by Inland Revenue is broadly recognised as a successful feature of the system that also facilitates the entry of new funds into the market (box 3.3).

In Australia, clearing house services for superannuation have traditionally been the province of the private sector, including payroll operators and some funds. However, those services are contingent on members or employers providing the fund and account details. They would not address situations where the employee inadvertently fails to provide those details. And a fragmented system is not conducive to capturing economies of scale that would arise from a centralised approach.

The SuperStream reforms recently implemented by the ATO have already established some foundations for a centralised clearing house. Employers must now pay their superannuation contributions to superannuation funds electronically, and the payment is linked to a unique payment reference number, which is automatically sent to the ATO for compliance monitoring. The system allows employers to make the contributions for all employees in a single transaction, even if the money is going to multiple funds. The ATO has also developed a small business clearing house service, albeit with limited functionality. Developing a centralised clearing house and housing it within the ATO would be a natural extension of this recent work. However, the Commission acknowledges

that this would involve a significant change to the role traditionally undertaken by the ATO in superannuation.

#### Box 3.3 **Inland Revenue's role as a clearing house**

Inland Revenue uses New Zealand's pre-existing income tax system for its clearing house role. Employers deduct employee contributions, make compulsory employer contributions and remit these directly to Inland Revenue. Inland Revenue transfers KiwiSaver contributions to each employee's relevant KiwiSaver scheme provider (Inland Revenue 2017).

The clearing house is widely considered to be a critical and successful part of KiwiSaver. The Commission consulted with KiwiSaver funds, New Zealand government organisations and academics, most of whom highlighted what they consider to be the clearing house's benefits:

- · ensuring each individual has only one KiwiSaver account
- · low administration costs for employers and funds
- the ease with which Inland Revenue can monitor employers' compliance with mandatory contributions
- simplicity for funds facilitates market entry and competition between providers.

One drawback noted by some parties is that Inland Revenue does not have up-to-date contact details for all employees, making it harder for providers to communicate with their members. (However, this issue would likely still exist under a different system.)

#### Regulation should promote competition

Irrespective of the allocation model selected, the regulatory regime governing the system (both the content and administration) should be conducive to broader competition in the system and not create any impediments of its own. For example, mergers and acquisitions can be a way to inject competition for the default market. Participants in the Commission's stage 1 study (PC 2016), as well as this inquiry, identified several areas where more effective regulation of the system could potentially improve competition and outcomes for members.

#### Improved disclosure of fund costs and fees

The current lack of transparency on fund fees and costs was a key theme for many participants in the stage 1 study (PC 2016, pp. 193–194). Problems with fund disclosure included misattribution of costs and fees (across investment and administration), missing or inconsistent data for some types of costs (for example, indirect and related party costs) and a likely misalignment between the structure of member fees and underlying costs.

This lack of transparency is likely to materially impede both member- and regulator-driven competition between funds. On the regulator side, the Deputy Chairman of APRA (Rowell 2016) observed that there needed to be far greater transparency on the underlying

costs of running a superannuation fund for APRA to be able to put pressure on the funds to reduce costs or merge with a more efficient fund. Of even more direct relevance to this inquiry, the lack of transparency will further complicate the task of the body responsible for selecting default products.

#### Successor fund transfer rules

An important consequence of the competitive process is that it should enable efficient exit of funds (chapter 1). Current successor fund transfer rules are a potential barrier to this process. The regulations impose a requirement on trustees of funds wishing to exit and transfer their membership via a 'bulk transfer' to meet an 'equivalent rights' test (r. 1.03 of the Superannuation Industry (Supervision) Regulations 1994 (Cwlth)). This is combined with the general requirement under section 52 of the *Superannuation Industry* (Supervision) Act 1993 (Cwlth) that the trustees of both funds act in the best interests of members.

Some participants in stage 1 argued that, in the absence of clear guidance by APRA, trustees interpreted the test conservatively and would not consolidate unless they could establish literal equivalence of all rights for every member in both funds. A frequently cited example was the difficulty in securing equivalent terms and conditions for bundled insurance. The Commission concluded that the rules could be a material barrier to efficient consolidation if they prevented mergers that would benefit the member group as a whole, while leaving some members worse off.

More recently, APRA (2016) has released new draft guidance for successor fund transfers, which if implemented, could address the concerns about a literal interpretation of the rules. Specifically, the guidelines indicate that equivalent rights only apply to legally enforceable rights of members (such as the right to accrued balances). They would not apply to product aspects, such as the insurance offering, and the level of fees, product features and investment options for the accumulation product. The guidelines also propose that trustees can assess groups of members with common characteristics rather than examining the right of every member.

The Commission will monitor the development of these guidelines, but considers the draft document to be a step in the right direction.

#### Transparency around merger proposals

The stage 1 report (PC 2016, p. 96) noted the debate in the industry about mergers not going ahead due to principal—agent problems. Several stakeholders have contended that some trustee board directors (and their sponsoring bodies) have an incentive to avoid mergers that would force them to relinquish their position on the board.

The Commission will not take a view in this inquiry on the relative merits of different board structures. However, it recognises that there is a general lack of transparency for members and APRA in situations where a fund was approached for a merger, but the merger did not go ahead. This is in stark contrast to what is required of listed companies under Part 6.5 of the *Corporations Act 2001* (Cwlth). The latter clearly specifies the takeover procedure and requires anyone making a takeover bid to disclose this information to the Australian Securities and Investments Commission (ASIC) and the shareholders of the company targeted for the takeover. The Act also requires directors of the targeted company to respond with statements to ASIC, the bidder and their own shareholders.

#### Rice Warner (sub. 43, p. 10) argued:

The issue appears to be with the processes by which those proposals are considered and how decisions are reached in the best interests of members. The process would be enhanced by a formal framework for approaches and the consideration of those approaches.

While trustees already have a general obligation to act in member interests, there is merit in Rice Warner's proposal to introduce a formal framework specifically for mergers to provide confidence to members and APRA that the trustee is discharging this obligation. The Commission agrees with Rice Warner that the framework should include:

- clear guidelines for funds on how to approach another fund with a merger proposal
- an obligation for trustees to give genuine consideration to merger proposals in the context of member interests
- disclosure by trustees to their members and APRA of all merger approaches and the reasons for any decisions.

#### **DRAFT RECOMMENDATION 3.3**

The Australian Government should introduce a formal framework that specifies the process and obligations of trustees when making or considering merger proposals. As part of the framework, trustees would be required to disclose all merger attempts involving their fund, as well as the reasons for any decisions.

#### **INFORMATION REQUEST 3.2**

The Commission is seeking feedback on the merits and implementation issues of its proposal to improve transparency around fund merger activity.

- What (if any) complementary regulatory action would be needed to ensure that the framework is effective in promoting mergers and the exit of underperforming funds?
- Are there any likely unintended consequences from introducing the proposed framework? To what extent, and how could those unintended consequences be addressed through policy design?

## Annex Estimating the effects of alternative definitions of new default members

The definition of a new default member affects the size and composition of the default market contested by funds, as well as the proliferation of default superannuation accounts within the system. The Commission has estimated some of those effects under the current 'labour turnover' definition and the 'first-timer' definition proposed by the Financial System Inquiry. These estimates are not a precise assessment and are only intended to provide an order of magnitude of the effects.

#### Size of the market

ATO data on the number and taxable income of members that open a new superannuation account each year, and the number of accounts they opened, were used to provide an indicative estimate of the size of the pool of default members for the turnover scenario (table 3.4). To derive the number of members and accounts in the turnover pool, the Commission applied a 70 per cent default rate to the aggregate member and account data provided by the ATO. The default rate is based on a survey by Delpachitra and Rafizadeh (2014) and is also consistent with a 2010 survey by Roy Morgan, cited by Cooper et al. (2010). 18

For the first timer pool, the Commission used ATO data on the number of members opening an account for the first time each year and assumed that each member would only hold one account. The Commission assumed a 90 per cent default rate, in line with broader findings in the literature that young people are more likely to default (PC 2016). In calculating the value of the contributions from the first-timer group, the Commission drew on average income estimates for that group provided by the ATO. The estimated value of contributions underestimates the longer-term attractiveness of each year's cohort, because it is effectively based on the average income of a person when entering the workforce. Applying average incomes of the turnover pool to the first-timer cohort yields a pool of over \$2 billion per annum.

#### Member switching behaviour is not incorporated into the estimates

Many of the factors that would drive the relative value of the two pools cannot be estimated. The Commission has not attempted to predict the switching behaviour under either scenario. For example, the estimate of contributions in the turnover pool may understate its short-term attractiveness to the (unknown) extent that existing members may consolidate balances from an established account into the new default product. Many funds actively market this option to new members. Conversely, the value of the turnover pool would decline if members carry over their existing account into a new job. And all account

<sup>18</sup> The latter found an 80 per cent default rate.

consolidation activity under the current arrangements would reduce the estimate of account proliferation in the turnover scenario.

Table 3.4 Indicative size of the turnover and first-timer pools<sup>a</sup>

	Turnover pool <sup>b</sup>	First-timer pool <sup>C</sup>
Number of accounts	1 070 000	410 000
Number of members	960 000	410 000
Average income	\$56 800	\$21 400
Value of contributions	\$5.2 billion	\$0.8 billion

<sup>&</sup>lt;sup>a</sup> Average per year, between 2013-14 and 2015-16. Income and value of contribution estimates expressed in 2015 dollars. 
<sup>b</sup> Based on the number of people opening accounts, the number of accounts they opened and a 70 per cent default rate. 
<sup>c</sup> Based on the number of people opening accounts for the first time and a 90 per cent default rate. Assumes one account per person.

Sources: ATO (pers. comm., 24 January 2017, 15 February 2017).

Consequently, the estimates for the value of the turnover pool and the number of accounts that would be removed from the system due to moving to the first-timer approach are presented only to indicate an order of magnitude of the impacts.

#### Fund membership demographics

To provide context for the estimate of the first-timer pool, the Commission examined the demographic distribution of member benefits in APRA-regulated funds (table 3.5). Nearly three-quarters of total member assets in APRA funds, and well over half of assets in MySuper products, are held by those who are over 45. This contrasts with the demographic distribution of new entrants into the system — of whom about two-thirds are younger than 25 (figure 3.4). The flow of contributions from the first-timer pool would be material in the context of the cohort of existing young members — those that are most relevant for the longer-term sustainability of the funds.

		<25	25–44	45–54	55+	Total
All APRA funds	Value of benefits (\$b)	11.7	306.0	299.2	603.4	1 220
	Share of total (%)	1	25	25	49	100
MySuper products	Value of benefits (\$b)	9.3	191.2	138.5	117.5	457
	Share of total (%)	2	42	30	26	100

<sup>&</sup>lt;sup>a</sup> Does not include the benefits of members whose age was not reported. Those members account for fewer than 1% of balances, for both MySuper products and APRA funds overall.

Sources: APRA (2017a, 2017b).

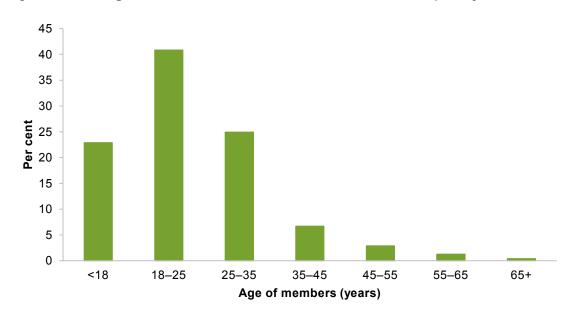


Figure 3.4 Age distribution of new entrants into the super system<sup>a</sup>

## Savings in administrative fees and insurance premiums from reduced account fragmentation

A reduction in the number of default accounts would lead to savings to members in account administration fees, as well as in the price of duplicate bundled insurance policies. These gains to members would be cumulative — every year there would be fewer accounts opened relative to current arrangements, leading to an additional long-term stream of cost savings.

Chant West (2016) estimated the average fixed component of the administrative fee on a MySuper account at \$75. Given the indicative nature of the estimates, the Commission assumed that this value would remain constant under the turnover and first-timer scenarios. This implies total annual fee savings of about \$45 million for every permanent reduction of 600 000 accounts relative to the turnover scenario.

Estimating the savings in insurance premiums paid by members from reduced duplication of bundled insurance is challenging, particularly due to the complexity and heterogeneity of the policies. The Commission assumed an average premium of about \$255 per annum on the basis of aggregate APRA (2017c) data on premiums collected and the number of accounts with bundled insurance. The Commission also assumed that 20 per cent of default members in the turnover pool opt out of bundled insurance when they open a new default account. The latter implies that for every reduction of 600 000 default accounts, there

Average for the period 2013-14 to 2015-16.
 Data source: ATO (pers. comm., 10 January 2017).

would be a reduction of about 500 000 bundled insurance policies. Accordingly, *every* permanent reduction of 500 000 bundled insurance policies relative to the turnover scenario could lead to annual cost savings to members of over \$100 million.

Overall, the savings to members in administrative fees and insurance premiums from removing between 500 000 and 600 000 accounts from the system would be of the order of \$150 million per annum.

#### INFORMATION REQUEST 3.3

The Commission is seeking comment on its approach to, and alternative ways of estimating the size and value of, the turnover and first-timer pools and the benefits from reducing account proliferation due to moving to the first-timer approach.

## 4 The baseline

#### Key points

- The Commission has used a baseline of no default arrangements. This would require employees to choose their own superannuation product — described in this report as unassisted active choice.
- The baseline is not an alternative model being considered by the Commission the performance of the alternative models relative to the baseline is what matters.
  - The baseline also focuses attention on what an absence of default arrangements would imply for members in today's superannuation environment.
- A world without default arrangements has a number of positives.
  - The supply side of the market would be contestable and rivalrous, lending itself to strong competition. Such organic competition is an important driver of innovation over time.
  - It minimises the number of formal principal—agent relationships and encourages more members to engage with their superannuation.
  - It imposes a minimal regulatory burden and has low risk of system instability.
- Despite these positives, such a baseline also exposes serious weaknesses inherent in compelling people to make complex long-term financial decisions that some may find difficult.
  - Although employees are notionally free to act in their own best interests, cognitive constraints, behavioural biases and inadequate information can limit their ability to do so. Moreover, compulsory membership in the system inevitably exacerbates disengagement.
  - There is scope for unhealthy or wasteful competition (including marketing) in the market
  - Employees are likely to rely on advice from third parties (such as employers and financial advisers) when making their decision, but potential conflicts of interest can lead some employees astray.
  - Employees face the bulk of the costs of allocation, including search costs.
- In this inquiry, alternative models need to beat the baseline to be considered viable, and then prove workable.

The Commission's task for this inquiry is to develop and assess alternative models for allocating default members in the superannuation system to products. The Commission's assessment of alternative models requires a common reference point for comparison: a baseline. This chapter establishes the baseline for this inquiry.

It is important to note that the baseline is not an alternative model in itself — but is used as a tool to assess alternative models proposed by the Commission. For this purpose, the no defaults approach has been labelled as 'unassisted active choice' — a baseline that requires employees to choose a superannuation product without assistance.

The baseline was primarily chosen to identify and understand the problems that would arise under a completely decentralised allocation mechanism (chapter 2). This guides the Commission in developing alternative models that directly address these problems — the rationale for government intervention using defaults.

Characterising and assessing an unassisted active choice baseline is not without its difficulties. There is no obvious precedent in Australia or internationally that can provide real-world evidence for how a compulsory retirement savings market without defaults would function; but neither is that essential unless the intent is to apply such an approach.

Further, many participants questioned the use of a no defaults baseline, suggesting that it lacks analytical rigour, is difficult to operationalise and could yield misleading results (chapter 2).

However, there are several ways to gather evidence to inform the baseline. These draw upon established and tested economic principles and analysis, academic research, current system settings, and lessons from similar markets. The Commission has gathered evidence to provide a reasonable analysis of how employees would behave in an unassisted active choice world to provide a qualitative assessment of the baseline and address participant concerns.

This chapter begins by establishing the main characteristics of the baseline to give an idea of how it would work in practice (section 4.1). Then, section 4.2 assesses the baseline against the Commission's five assessment criteria (described in chapter 2). This is useful for two reasons. First, it identifies the potential problems of the baseline in order to guide the development of alternative models. Second, the assessment provides a common point of comparison for the alternative models.

## 4.1 Establishing the baseline

The Commission's baseline for this inquiry is a world of unassisted active choice and thus no defaults. The defining characteristic of the baseline is that it places the onus entirely on the employee to choose a superannuation product.

The baseline reflects an objective 'first principles' approach to a standard competitive market: the consumer (employee) chooses and directly purchases a service (superannuation product) provided by a supplier (superannuation fund). By using a completely decentralised approach to product allocation, an assessment of the baseline helps identify possible market failures and indicates the problems to be addressed through government intervention in alternative default models.

The baseline has two key characteristics. First, employees would be required to choose a superannuation *product* to receive their employer contributions. There would be no default products that employees are automatically allocated to if they do not make a choice. Second, employees could choose from any publicly offered *legally complying* superannuation product available in the market. All employees would have unrestricted choice. This means there would be no role for workplace instruments to allocate employees to funds or products.

Importantly, superannuation products would still be subject to today's prudential, competition and consumer laws and regulations. This is significant because unassisted choice does not mean *no* regulatory standards at all. Further, regulatory advances since the introduction of the compulsory superannuation system in the early 1990s may have lessened some problems that the default system was originally designed to solve. For example, changes in product disclosure standards have improved transparency and comparability of products over time.

A legally complying product in unassisted active choice would be any product offered by a superannuation fund regulated by the Australian Prudential Regulation Authority (APRA), Australian Taxation Office (ATO) or other legislation (exempt public sector superannuation schemes). In 2016, there were over 200 large superannuation funds regulated by APRA, offering more than 40 000 investment products, many of which were open to the public (APRA, sub. 32, pp. 7, 13 to PC 2016). In addition, employees can set up a self-managed superannuation fund if they wish to have complete autonomy over their investments. By June 2016, there were over 577 000 self-managed superannuation funds (ATO 2016a).

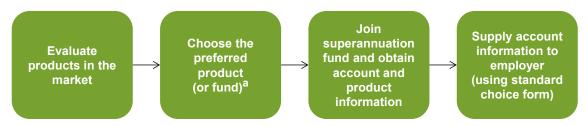
Under the baseline, choice is ultimately driven by employees. The current role played by employers in choosing a default fund would not apply. That being said, employers, unions or other intermediaries would be free to bargain with superannuation funds on behalf of employees to secure group discounts on fees. This would mimic the current practice offered by corporate funds or industry funds, the only difference being that employees would be under no obligation to choose that fund. Further, although the superannuation of most members is in defined contribution products (PC 2016, p. 32), there would be no restriction on employers and superannuation funds offering defined benefit products.

Similarly, product offerings would be decided by superannuation funds. This means that funds would determine their own fees, investment strategies and ancillary services. Importantly, current legislation requires superannuation funds to offer a minimum level of insurance in their default products. However, given there are no default products under the baseline, funds would not be subject to this requirement. Funds would be free to offer products with or without insurance as part of their product offering, noting that some legislative provisions and regulations may apply to *how* funds offer and provide insurance to members.

In practice, employees would follow a simple process for choosing a superannuation product (figure 4.1). Employees would ultimately be responsible for evaluating available

products in the market and choosing their preferred product or fund. Third parties can also assist employees in making their decision, such as employers, unions, financial advisers and private ratings entities. Once the employee has chosen a product, they would be responsible for joining the fund and obtaining their product and account information. They would then provide the account details to their employer in a similar process to filling out the current superannuation 'standard choice form' (ATO 2015b), but without any default option. In addition, and mimicking the current rules, the employee would be required to obtain a letter from the fund stating that it can receive contributions from their employer (ATO 2015b, p. 2). This process is available now on many larger super fund websites.

Figure 4.1 Illustrative process for employees to choose a super product



**a** An employee can choose just the *fund* (not the specific product) if the fund automatically allocates them to a product. However, they would still be required to provide the account number to their employer.

This active choice nomination process is not novel. It mirrors the current process whereby new employees are required to choose their own bank account and provide the details to their employer in order to receive wages.

In an unassisted active choice world it is possible that some employees will either refuse or fail to make a choice. It is difficult to predict how many employees will fail to nominate a product. Nonetheless, the Commission considers that nonresponse is generally likely to be low. In a related example, Carroll et al (2009, p. 1643) studied a natural experiment whereby employees were required to actively choose whether to enrol in a retirement plan within 30 days of being hired. Five per cent of new employees failed to return the form.

Under the baseline, there would be significant consequences for non-responding employees and their employers. Non-responding employees would forfeit their employer contributions, as the employer would have nowhere to make the payments. And given that employers are under a legal obligation to make these contributions, they could face substantial consequences if these obligations are not met (Ai Group, sub. 21, p. 4).

Under the current rules, employers are only required to make contributions quarterly (ATO 2015a). This is likely to give new employees time to choose and nominate a superannuation product. In addition, the threat of non-compliance action from the ATO may act as an incentive for the employer to follow up with the employee on their choice of fund. It is reasonable to assume that eventually a product would be nominated, but delay and uncertainty ultimately impose a cost to non-responding employees.

# 4.2 Assessing the baseline

This section assesses the benefits and costs of the baseline against the five criteria outlined in chapter 2 — member benefits, competition, integrity, stability and system-wide costs. After discussing the benefits and costs against each criterion, this section summarises the overall assessment of the baseline.

#### **Member benefits**

The first assessment criterion focuses on whether the allocation process creates incentives for funds to maximise long-term net returns and allocate members to products that meet their needs.

### Employees can often struggle to make good decisions

Employees ultimately represent the demand-side of the superannuation system. Under the baseline, employees would be free to make decisions in their own interests. They could bargain directly with suppliers (or use an appointed agent) and choose a superannuation product according to their own risk tolerance and personal preferences. Or, they may make a choice at random. Further, unions, employers and other agents would be free to negotiate with suppliers to secure group discounts on fees for a particular cohort of employees, such as those currently available to corporate funds. However, the incentive to do so may well be reduced by the fact that in an unassisted active choice world, no *default* regulation would exist to guide them to join such an option. There would also be no legal constraints on employees that restrict their ability to choose a product or an agent.

However, employees do not always make decisions in their best interests. Freedom to choose means they may choose products that are likely to result in worse retirement outcomes relative to outcomes from other available products. For example, employees may choose products with higher fees, poorer investment performance or pay for additional services (such as a plethora of investment options) they do not need. Further, many employees may choose overly conservative products, reducing their potential retirement income. There is evidence that many people fail to properly consider risk when diversifying assets (Benartzi and Thaler 2007, p. 86), are excessively sensitive to financial losses relative to gains (Kahneman and Tversky 1979, p. 263), and can be slow to move out of underperforming products (Bateman et al. 2016a, p. 20).

There are a number of reasons why employees may make poor decisions — especially long-term decisions such as superannuation. People can struggle when making long-term decisions due to various constraints, heuristics and behavioural biases (box 4.1). They are also not always confident in making financial decisions or where to look for help, and they can be easily misguided by irrelevant information or advice that is not in their best interest.

Moreover, compulsion in superannuation (in part created to address some of these constraints and biases) inevitably exacerbates disengagement of members — a characteristic present under the baseline as well as any alternative allocation model.

Given that people generally join the workforce at a young age, most people who are required to make a decision under the baseline (and all the models) are young. In fact, about one quarter of members are under 18 when they are first prompted to choose a superannuation product (chapter 3). It is then particularly concerning that younger people tend to show little interest in their superannuation and are particularly vulnerable to making poor decisions. In a 2014 survey of 25–35 year olds, Ali et al found serious deficiencies in the superannuation knowledge, behaviours and attitudes of young adults.

Knowledge of basic facts about superannuation is poor. Young adults are unengaged by and uninterested in superannuation or retirement planning. Attitudes can be described as worried and sceptical. (Ali et al. 2014, p. 1)

Rice Warner (sub. 43, p. 6) shared this concern, noting that many young people hold too many accounts (an outcome encouraged by the current default system), pay high fees relative to their balances, and pay for excessive insurance relative to their needs.

#### Box 4.1 Constraints, heuristics and behavioural biases

#### Constraints on decision making

When people face complex problems, such as retirement planning, behavioural economics suggests they do not always make decisions in their best interests. There are several possible reasons for this. For example, Mullainathan and Thaler (2000, p. 2) suggest people do not always put their interests first (bounded self-interest) or may lack the willpower (bounded self-control) to carry out their intentions. Further, in a well-known view, Simon (1955) proposed that people face 'bounded rationality' in the presence of three main constraints:

- cognitive constraints people find it difficult to compute complex problems
- time there are limits to the time people have available to solve problems
- imperfect information relevant information may not be accessible or understandable.

A prominent example of a constraint in the superannuation system is the large number of products available for employees to choose from. The need to decide between an excessive number of options can lead to 'choice overload' and lessen an employee's motivation to choose. Iyengar, Huberman and Jiang (2004) show that when people are presented with a greater menu of superannuation investment options to select from, they are less likely to participate in a retirement savings plan.

(continued next page)

#### Box 4.1 (continued)

#### **Heuristics**

Given these constraints, people often resort to using mental rules of thumb or shortcuts — commonly termed 'heuristics' — to simplify problems and make decisions. There are many different heuristics people use when making retirement decisions.

Benartzi and Thaler (2007, pp. 84–86) noted that people with US retirement savings accounts choose contribution rates in a number of ways, for example: choosing multiples of 5 per cent; matching the employer contribution; or simply choosing the maximum allowed. Further, people tend to diversify when choosing their asset allocation, often dividing their assets evenly across a subset of the available options — termed the 1/N heuristic. In addition, people may rely on patterns in a small sample of information (representative heuristic), may only rely on readily available information (availability heuristic) or rely on the default option (default heuristic) (Tversky and Kahneman 1974).

#### Behavioural biases

While heuristics can be useful in making decisions under constraints, they can also introduce systematic biases into decision making. These biases can prevent people from taking account of all relevant and available information, making it difficult to act in their best long-term interests.

- Status quo bias researchers have observed that many people display procrastination (delaying decisions) and inertia (failing to revise decisions) when saving for retirement (Clark et al. 2013).
- Framing bias experiments have shown that the way information is presented, such as a menu of investment options, has a strong effect on the portfolio people choose. For example, anchoring can occur when people rely heavily on one trait or piece of information when making a decision (Mitchell and Utkus 2004).
- Loss aversion experiments show that people tend to be more sensitive to financial losses than gains of the same amount (Mitchell and Utkus 2004).
- Familiarity bias some investors may prefer to invest in shares of companies they are familiar with because they view it as less risky than others (Clark et al. 2013).
- Present bias and myopia research suggests that some people focus on short-term consumption to the detriment of long-term consumption. In particular, some people may be subject to 'hyperbolic discounting', whereby the time value of money is discounted more heavily in the near term than the long term. Indeed, one of the reasons superannuation is compulsory is to mandate savings because people may not do so on their own accord (Goda et al. 2015; Mitchell and Utkus 2004).
- Compulsion it is inevitable that some people who are compelled to make superannuation contributions may not be interested in or capable of making any relevant decisions, leading them to disengage from the decision-making process (Fear and Pace 2008, p. vii).

Beyond disengagement, simple lack of awareness can also compound the problem. Between 2002 and 2014, about 2 per cent of people surveyed every three years were not aware that employers are required to make superannuation payments on behalf of their employees (ANZ 2015, p. 71). Employers of such employees may fall short of their

Superannuation Guarantee requirements, but the extent to which this occurs even today is subject to debate and will likely be examined by the Commission in its stage 3 inquiry.

Collectively, these problems have the potential to lead some employees astray, choosing products which either perform poorly or do not meet their needs. Several submissions echoed these concerns about the quality of employee decision making under unassisted active choice (for example, First State Super, sub. 26, p. 2; Kinetic Superannuation, sub. 45, p. 6).

Alternative models should demonstrate how, and how effectively, they can address these problems in employee decision making.

# What does unassisted active choice mean for member engagement?

Much of the evidence on member disengagement is drawn from a world of defaults that may perversely encourage it. A significant benefit present in the baseline, but less evident under other default arrangements, is that requiring employees to interact with their superannuation by making active choices can potentially drive member engagement (ASFA, sub. 24, p. 21; Carroll et al. 2009, p. 1641; FSC, sub. 38, p. 16).

Under the baseline, there are significant penalties for indecision — if an employee fails to choose a product, they may miss out on contributions. This penalty can be expected to act as an incentive for employees to evaluate and engage with their superannuation in order to make a choice. In fact, researchers have examined how an unattractive default option can encourage people to make their own active choices (Carroll et al. 2009). For example, New Zealand's use of a very conservative investment default has led many people to change providers: about 34 per cent of members who were initially in a default fund in 2008 had transferred to a new provider by 2012 and another 5 per cent had switched investment options within the same default provider (MBIE 2012, p. 34).

Employees have the most to benefit from active and meaningful engagement. If employees feel encouraged to take an interest in — and educate themselves about — their superannuation, they are better placed to manage their savings in line with their individual financial situation and risk preferences. This is important because employees ' ... would have more information about their circumstances than any other decision maker' (ASIC, sub. 41, p. 3). Greater member engagement can also benefit employees by encouraging them to consolidate multiple accounts in favour of a single account. This can save employees from paying excess fees on multiple superannuation accounts.

Overall, the baseline is likely to encourage employees to engage with their superannuation. This is important because member engagement can drive overall market (demand-side) competition within the superannuation system, improving system-wide efficiency. Alternative models will have to offer ways of improving on member engagement if they are to improve upon the baseline.

#### Greater choice benefits from better information

Members may not engage with their superannuation, or struggle to make decisions, because there are problems with the information they use. In the superannuation system, useful information is not always available (PC 2016, p. 193). Information tends to be complex, can be hard to access or is not always consistently disclosed. This makes it difficult to compare options, especially given the plethora of superannuation products available in the market. These information problems lead to high search costs for employees, who often have to spend a lot of time and effort to find, understand and evaluate information in order to make meaningful decisions.

Consumer protection regulations can help improve the usefulness and transparency of information, but they are not a silver bullet. For example, the Australian Securities and Investments Commission (ASIC, sub. 41, p. 2) aims to improve information transparency and comparability in the superannuation system through its ongoing work with product dashboards and product disclosure statements. Further, the private sector already provides easily accessible information and comparison tools that employees can use to simplify their decision making and reduce their search costs. But, as noted by ASIC the effectiveness of all of this information is ultimately limited by the extent to which consumers are willing to use it.

Disclosure initiatives ... while useful for consumers, cannot deliver investor protection and effective competition on their own. In part, this is driven by consumer disengagement and behavioural factors constraining the effectiveness of these disclosure measures. (ASIC, sub. 35, p. 2 to PC 2016)

Under the baseline, superannuation funds can be expected to lift their efforts to actively inform potential members of their services and performance in order to attract and retain members. Undoubtedly, there is a cost to providing this information. But, no matter who provides it, there will always be a cost associated with improving information in the superannuation system. Absent the option of a single sovereign fund (chapter 3), there are only two pathways to address information asymmetry: increase the availability and quality of information (at a cost) or limit choice to a smaller set of funds.

In an assessment of competitive models, which is the task of this inquiry, choice is a given and thus improved consumer information is likely necessary. Therefore, all models will face the cost of information provision to some extent. That said, the relative cost will be an important consideration as to whether and how competitive allocation can work.

### Other industries experience similar consumer decision-making problems

In order to understand the impacts of unassisted active choice on the superannuation system, the Commission looked at the way consumers make decisions in similar industries. Other markets, such as residential home loans, electricity and private health insurance, rely on consumers actively making difficult decisions (box 4.2).

#### Box 4.2 Consumer decision making and competition in like markets

Superannuation has similar qualities to other markets in Australia that rely on active choice. Consumers often face the same difficulties in decision making and suppliers are subject to a similar landscape of competition.

#### Residential home loans

Residential home loans share many of the same characteristics as superannuation. Consumers struggle with similar decision-making problems, such as cognitive constraints and behavioural biases (Skelton 2015, pp. 65-94). However, they are still expected to make complex financial decisions between products with varying features and long-term consequences. This can lead them to taking on home loans that are unnecessarily costly or do not meet their needs. For example, some market aggregators suggest that the highest and lowest home loan interest rates can differ by about 2 percentage points (Canstar 2016; RateCity 2017).

Further, banks face similar barriers to entry and exit as those found in superannuation, including scale, vertical integration, regulatory requirements and incumbency advantages (CIFR 2015, p. 92; Deloitte Access Economics 2014, pp. 29-34). However, rivalry is more limited. While products are somewhat homogenous and many substitutes are available, the market is dominated by the big four banks, which consistently retain over 70 per cent of the market share for household loans (CIFR 2015, p. 58).

#### **Electricity**

While not a completely unassisted choice market (State Governments provide comparison websites), studies of consumer attitudes in Australia's electricity market show consumers generally have a low level of interest or understanding of electricity or its pricing, and are likely to be more interested at specific times (such as signing up to electricity services) (AEMC 2012, p. 43). In particular, vulnerable consumers experience some of the same behavioural biases found in the superannuation system, such as inertia and loss aversion (AEMC 2016, p. 46).

Competition in retail electricity markets is also similar to that in superannuation. There are several regulatory barriers to entry, such as price regulation and regulatory uncertainty (AEMC 2016, p. 91). Overall, there is strong retail competition in most jurisdictions (AEMC 2016, pp. i-iii). Consumers can receive significant discounts (in the order of hundreds of dollars a year) by switching to a more competitive offer. But disengagement can leave consumers paying more. For example, the AEMC (2016, p. iii) suggests that consumers who have not switched electricity retailers in the past five years could probably find a better deal.

#### Private health insurance

About half of all Australians have private health insurance (ACCC 2015, p. 6). Like superannuation, regulatory settings encourage consumers to obtain private health insurance through insurance rebates and the Medicare Levy Surcharge. However, imperfect information and complexity in decision making can cause consumers to disengage from their private health insurance and choose policies with little value. For example, research shows that while consumers engage at the start of the purchasing process, many who think about changing their arrangements fail to do so (ACCC 2015, p. 29). In addition, many consumers are thought to hold 'junk' policies that provide them little value (CHOICE 2016).

Contestability issues in the private health insurance market closely resemble those in superannuation. For example, barriers to entry include prudential capital requirements, product regulation, incumbency advantages and economies of scale (PHIAC 2015, pp. 14–21).

Some inquiry participants suggested that superannuation is not necessarily comparable to other industries or products, such as bank accounts, as the decisions are more complex and made for the long term (ASFA, sub. 24, p. 22; IFAA et al, sub. 13, p. 6; Mercer, sub. 15, p. 4). Further, involvement in the superannuation system is compulsory.

However, the Institute for Public Affairs likened superannuation to other industries, arguing that:

In the same way that these entities are not involved in the selection of employee bank accounts, electricity or telecommunications providers, the selection of a superannuation fund should ultimately be a matter for an employee alone. (IPA, sub. 17, p. 8)

Overall, this does not mean that other markets offer no useful insights and lessons. The industries in box 4.2 tend to cater to most Australians and some of the decisions, such as choice of home loan, can be complex, made for the long term, and have very large financial consequences. Moreover, a mortgage is harder to unwind (penalties, significant documentation) than a shift across super funds; and comparisons of health insurance products are particularly difficult to assess given an individual's need (expectation of making a claim) is far less certain than their eventual retirement.

Viewed in this way, the superannuation default system might be considered an outlier in terms of intervention.

# Competition

The second assessment criterion focuses on encouraging open participation (contestability) and rivalry between funds (competition) that drives innovation, cost reductions and more efficient long-term outcomes for members.

Competition on both the demand and supply sides of the superannuation system can be useful in improving outcomes for members, by reducing prices or increasing service quality (PC 2016, p. 65).

The baseline is the purest form of competition. There are few regulatory constraints on the demand side — employees are free to choose any superannuation product that meets their needs. However, some aspects of the system naturally distort the signals members send to superannuation providers. As noted above, some employees are disengaged or fail to make decisions in their own best interests. This softens the pressure on superannuation funds to provide their services at or close to the underlying costs of provision.

That said, the threat of switching by engaged employees under the baseline may exert enough competitive pressure on funds, driving better outcomes for all members. And as noted earlier, engagement is encouraged under the baseline conditions.

#### The baseline is highly contestable ...

On the supply side of the superannuation system, the baseline imposes few material constraints on providers. The baseline is considered to be highly contestable given there are low barriers to entry (ASFA, sub. 24, p. 21; FSC, sub. 38, p. 16). This contestability allows superannuation funds to compete in the same way as suppliers in other competitive markets.

The Australian Competition and Consumer Commission (2008, p. 40) classifies barriers to entry and advantages of incumbency as regulatory, structural or strategic. Under the baseline, some barriers to entry and incumbency advantages exist.

- Regulatory barriers under the baseline, superannuation funds are subject to similar regulatory barriers to entry as most other financial service providers, including competition, prudential and consumer regulations. Regulatory barriers are lowest under the baseline compared with alternative models.
- Structural barriers because superannuation is an investment service, there may be some structural barriers to new superannuation funds entering the market. These include advantages from economies of scale, large initial sunk costs, and access to distribution channels.
- Strategic barriers incumbency may act as a strategic barrier. For example, an incumbent fund can benefit from low product switching as a result of consumer inertia and can also benefit from advertising historical investment performance.

While these barriers to entry persist under the baseline, they will generally also be present under any alternative model. Further, these barriers tend to resemble those found in similar competitive markets (box 4.2). And while they may present some challenges for new entrants, they are not expected to be high enough to significantly diminish contestability. The more important question may thus be the degree to which any alternative model *adds* to the barriers to entry.

Along with barriers to entry, barriers to exit — the ability of providers to leave the market or merge with more efficient competitors — is an important condition for competition that drives efficiency.

Under the baseline (and all the models), the complex process for funds to wind up and exit the market is likely to remain, and there are some regulatory barriers to mergers along competition, prudential and consumer protection lines. For example, some have argued that bulk transfer rules — which require the successor fund to give the new members equivalent rights to those in the original fund — restrict potential mergers (chapter 3).

The case of fund exits relative to the baseline will be particularly interesting — models that deprive most of the current 100 odd MySuper products of access to default inflows will undoubtedly hasten exits. Indeed, APRA stated that consolidation of funds via mergers may promote efficiency in the system (APRA, sub. 32, p. 6 to PC 2016). While it is

unclear whether the baseline would encourage mergers, some alternative models may improve on this situation.

#### ... and there is strong rivalry between superannuation funds

The baseline also features a high degree of substitutability between superannuation products on the supply side. This is because many products are somewhat homogenous and employees are free to switch to new products. Given the baseline allows any fund to compete in the market, there would be many products available for employees to substitute into. There are currently more than 40 000 investment options in the market (APRA, sub. 32, p. 7 to PC 2016), and this high degree of substitutability could also be expected under the baseline.

Substitutability of products also drives rivalrous behaviour between superannuation funds, increasing the pressure to compete by lowering costs or increasing value to retain or attract employees. A common indicator of rivalry in the superannuation system is market concentration. Given there are more than 200 superannuation funds in the market, concentration under the baseline is low. Further, market concentration is likely to be low as there are low barriers to entry.

Strong competition can also be an important driver of innovation in the superannuation system. In a highly competitive market, funds would face strong incentives to innovate and become more productive in order to extract or retain profits and/or market share. Under the baseline, strong competition between superannuation funds can be expected to lead to more innovation over time (FSC, sub. 38, p. 17).

Overall, the factors that make up competition in the superannuation system — contestability and rivalry — are strong, and tend to mirror those found in similar markets, such as residential home loans, electricity and private health insurance (box 4.2).

#### There is scope for unhealthy or wasteful competition

Competition can improve outcomes for members, by either reducing prices (primarily fees) or increasing service quality (such as investment performance), or both. However, as noted by many inquiry participants, *competition is a means to promoting efficiency, not an end in itself* (for example, AIST, sub. 28, p. 3). This sentiment was also emphasised by the Commission in its stage 1 study.

There may be scope for unhealthy or wasteful competition under the baseline, whereby funds compete on attributes that are not in members' best interests and therefore detrimental to the efficiency of the system. In particular, superannuation funds may have an incentive to differentiate their product on non-price aspects and spend more on advertising (PC 2016, p. 107).

Some funds may differentiate their product by offering highly customisable investment options, perhaps in an attempt to attract or retain a small subset of members. Such products may offer an immediate benefit to the member, but their higher cost base will significantly erode that member's ultimate retirement balance. These problems can be exacerbated if funds do not adequately disclose the costs of these features.

Further, competition can be damaging to members' interests if it leads to advertising expenditure beyond what is socially optimal, although optimality may be particularly difficult to determine in such an environment. Several participants noted the potential for high marketing costs under an active choice process (Club Plus Super, sub. 32, p. 2; Vision Super, sub. 4, p. 10).

In general, the Commission considers that increasing competition in the market will invariably lead to increases in marketing and distribution costs.

There may also be situations where superannuation funds offer marketing incentives directly to employees in order to attract new members to the fund. For example, a fund may offer a discount on its administration fees for the first few years if an employee joins the fund. Currently, it is not illegal for a superannuation fund to give benefits to an employee as an incentive to choose their fund (ASIC, sub. 41, p. 4). Incentives start to become problematic when they are unrelated to the product and take advantage of behavioural biases by offering a short-term benefit at the expense of the member's long-term interests — for example, a free gift card or petrol voucher. However, drawing a line between a legitimate member benefit and an unhealthy inducement is nigh on impossible (chapter 5). While the extent to which this practice occurs in the current system is unclear, the risk of such behaviour by providers would likely be greater under the baseline.

These product differentiation and marketing strategies may be further amplified by the decision making difficulties faced by employees. If some employees fail to switch to superior products over time, this can reduce the pressure on rivalry between funds.

Overall, the baseline can be expected to encourage strong competition. However, there is scope for unhealthy and wasteful competition to impose some costs under the baseline, reducing its efficiency.

# Integrity

The third assessment criterion focuses on whether the allocation process promotes a high-degree of integrity in the selection and delivery of default superannuation products, and the ongoing behaviour of superannuation funds more broadly.

#### The number of principal—agent relationships are minimised ...

The nature of the superannuation system and the number and diversity of its participants have led to many principal—agent relationships: between employees, employers, funds, service providers, insurers and regulators. Problems can arise when there is a conflict of interest between the parties and the agent has the opportunity to exploit asymmetric information to act in their own interest to the detriment of the principal.

There are two determinants that impact the extent to which principal—agent relationships create problems.

- The number of relationships that exist between the employee and intermediaries. The
  greater it is, the greater the *opportunity* for intermediaries to exploit conflicts of
  interest.
- The extent to which conflicts of interest in these relationships impact on the employee's best interests.

Across all of the allocation processes, active choice minimises the *number* of these relationships. This is because the baseline requires all employees to have a direct relationship with their superannuation fund, minimising the number of *formal* relationships with intermediaries. This can reduce the opportunity for conflicting interests to lead employees astray.

That said, some intermediary relationships can provide value to members. For example, employers, unions and consumer groups can still seek to negotiate wholesale discounts on fees with superannuation funds to provide a superior product for a group employees. However, under unassisted active choice there are no regulations dictating this type of bulk purchasing and the employee would still have to choose to be involved.

#### ... but some scope for conflicts of interest still exists

The majority of Australians receive advice on financial matters, often from a variety of sources, such as specialists, banks, family or friends, superannuation funds and employers (ANZ 2015, p. 45). This can be very useful to members who want expert advice and help. However, this can become a problem when they are influenced by advice from parties with conflicting interests.

In principle, the more choice afforded by an allocation model, the greater the opportunity for advising parties to influence an employee's decision. This is particularly pertinent in the open choice world of the baseline. In the absence of a default option, new entrants to the workforce could be influenced to choose a particular fund by another party which has an affiliation or interest with a particular superannuation fund. The Australian Institute of Superannuation Trustees (sub. 28, p. 47) suggested that, under the baseline, new employees may essentially default to bank-related superannuation funds simply because this is the only financial relationship they have.

That said, while there may be scope for influencing members under the baseline, it would be a mistake to assume that those risks would not exist in any world involving significant rights to choose, including the current system. Moreover, since employers have no direct control over their employees' superannuation fund under the baseline, there is possibly less scope for them to influence their employees' decisions compared with an employer choice allocation mechanism.

Another relationship with potential for conflicts of interest is that between members and financial advisers. Under the baseline, the influence of financial advisers would most likely be higher than today. Yet the quality of that advice may not improve. Outcomes under the baseline benefit from the Future of Financial Advice reforms in 2013, whereby financial advisers face a legal requirement to act in the best interests of their clients (ASIC 2016).

In assessing alternative models against the baseline, the potential for conflicts of interest will need to be addressed. Similarly, any regulations designed to protect members can give rise to new, potentially conflicted, relationships. But since a rollback of consumer choice is not under consideration (chapter 2) it is not a fatal blow to either the baseline or any of the alternative models that such behaviours may be present.

# Stability

The fourth assessment criterion focuses on determining whether the allocation process creates instability in the superannuation system that leads to significant systemic risks. This can include excessive and volatile movement of members and assets between funds, unsustainable loss leading strategies or excessive market concentration.

Under the baseline, flows of members and assets between superannuation funds would likely rely on individual decisions and be driven by competition in the market in a similar way to other financial services, such as banking and insurance.

[Active choice] could also lead to relatively stable outcomes as individual decisions would be unlikely to lead to large shifts in market shares in the short term, with funds both gaining and losing members over time. (ASFA, sub. 24, p. 21)

Therefore, there would be no reason to expect sudden large-scale changes in the flow of members or assets between funds that impact on fund liquidity or peer risk.

Further, the baseline does not explicitly reward funds attempting to adopt an unsustainable loss leading strategy, and competitive market forces will generally act to prevent this behaviour or limit its effectiveness in the long term.

Finally, as noted above, there is no evident reason to believe the baseline would lead to market concentration between funds or upstream providers. Importantly, the baseline is still subject to current competition regulations. And like other financial institutions, superannuation under the baseline would still face prudential supervision by APRA, which monitors fund behaviour and industry trends in order to maintain a stable financial system.

Therefore, the baseline is unlikely to create instability in the superannuation system that leads to significant systemic risks.

## System-wide costs

The final assessment criterion focuses on minimising overall system-wide costs, taking into account costs to members, employers, funds and government.

## The cost of allocation ultimately falls on members

In an active choice world, members ultimately face the cost of choosing products. These members may face high search costs, and it has been suggested that transaction costs might also be significant.

Search costs mainly involve the time and effort expended by the employee to find, compare and evaluate products to determine which one is in their best interest. While the materiality of these search costs is unclear, a 2016 regulation impact statement estimated them at about \$87 per person based on an assumption that three hours would be required to research and choose a product (O'Dwyer 2016b, p. 25). Search costs may also include the upfront cost of purchasing professional advice to help make the decision. Therefore, imposing these search costs on a large number of members within the system means greater search costs overall at the system level. That said, disengaged members may forgo thoroughly searching for a product and rely on heuristics. In this case, the search costs would be lower, but so would the quality of the decision.

Members will also be faced with transaction costs: under the baseline, employees need to join the superannuation fund first and then provide the product details to the employer. Further, superannuation funds face the transaction costs associated with transferring members between funds. These switching costs may actually be desirable if they are the result of increased member engagement. But to the extent that suboptimal advertising encourages churn, this would be undesirable. Overall, there is no way of accurately attributing these effects.

There may be some merit in the argument that purchasing superannuation products as an individual is also likely to lead to higher costs relative to a group of employees negotiating on a wholesale basis (ASFA, sub. 24, p. 21). That said, the baseline has no restriction on the ability for employees or an intermediary negotiating a group discount on fees.

#### Minimal burden for most employers and superannuation funds

Under the baseline, the employer's role in the superannuation system is limited to making Superannuation Guarantee contributions on behalf of employees. Therefore, employers face potentially low regulatory and compliance burdens (ASFA, sub. 24, p. 21; FSC,

sub. 38, p. 16). Any employer wishing to be involved in their employee's superannuation decision can still offer a corporate fund for their employees to choose from or an education service to help members make a choice.

While there is an argument that employers may be required to send contributions to many different funds under the baseline, superannuation clearinghouses and the introduction of the ATO's Single Touch Payroll system are likely to alleviate this burden to a large extent (chapter 3).

Despite significant member engagement under the baseline, employers may face the burden of making sure all of their employees choose a product. This is because, if an employee does not choose a product, there is a risk that the employer does not comply with their Superannuation Guarantee obligations. It is difficult to estimate the extent of this burden at the system level under the baseline, but as already discussed, it is likely to be low. Further, it is worth noting that after 25 years of experience, most employers will be aware that failure to make employer contributions inevitably invites penalties.

Superannuation funds also face low regulatory burden. For example, funds would not face the costs associated with MySuper regulations. This minimises the regulatory costs that are passed through to members.

On the other hand, as noted above, intense competition between superannuation funds can be expected to spur significant marketing expenses aimed at retaining or attracting members. Not only will superannuation funds initially face higher marketing expenses, it is likely that at least a proportion of these costs will ultimately be passed through to members as fees (Vision Super, sub. 4, p. 10).

#### The overall cost to government

Under the baseline, there is likely to be little or no ongoing administration costs to government (ASFA, sub. 24, p. 21). The Government would have no additional costs above the ordinary competition, prudential and consumer protection regulations it currently provides to all financial markets. It is nevertheless possible to envisage that the ATO, with its sophisticated electronic connections to payroll providers and other employers, might face greater calls for proactive scrutiny that contributions are paid by employers. The Single Touch Payroll system appears capable of being used in such a fashion, albeit at a cost.

To the extent that there is an increase in members choosing poorly under the baseline, the government is likely to face greater costs in the long term. These members are more likely to rely on the Age Pension to provide or top up their retirement income (Mercer, sub. 15, p. 4). This may ultimately lead to significant fiscal costs to the Australian Government, borne by taxpayers. However, the extent to which this might occur is highly speculative.

#### **Overall assessment**

Overall, the baseline exposes some key problems with a completely unassisted approach to active choice allocation, which alternative models should aim to better. It also demonstrates several benefits that would be worth retaining. Table 4.1 presents a summary assessment of the baseline.

Table 4.1	The baseline: assessment summary	
Criterion	Assessment	
Member benefits	Members are free to act in their own interests and requiring active choice can trigger member engagement.	
	However, cognitive constraints, heuristics, behavioural biases and problems with information can lead some members to make poor long-term financial decisions.	
	Many superannuation funds can be expected to aim to attract new members, and in doing so improve the availability of information.	
Competition	Competition between superannuation funds is highly contestable and rivalrous. There are many similarities with other active choice markets.	
	However, there is scope for superannuation funds to engage in unhealthy and wasteful competition that is not in the interest of members.	
	Poor decision making and inertia can lead to low demand-side competition.	
Integrity	Members are required to engage directly with superannuation funds.  But there is potential for conflicts of interest, for example with financial advisers, which can negatively influence member decision making.	
Stability	Individual decisions by members are likely to lead to small and predictable member flows. This is supportive of system-wide stability.	
System-wide costs	The cost of allocation, particularly search costs, ultimately falls on members.  A minimal role for most employers leads to low administrative burden.	
	Superannuation funds face minimal regulatory burden, but are likely to incur significant marketing costs which are likely to be passed on to members.	
	The overall cost to government is likely to be low.	

Retirement planning is inherently complex and decisions need to be made over the long term. Cognitive constraints, heuristics, behavioural biases and imperfect information can lead some members astray, making poor decisions which are not in their best long-term interests. Thus members can potentially select products that do not meet their needs, such as products with high fees, poor investment performance, unnecessary services or overly conservative investments. Alternative models should aim to improve employee decision making or guide them to high quality products in other ways.

That said, the baseline benefits from giving all employees the freedom to act in their own best interest and prompting more employees to engage meaningfully with their superannuation. Alternative models should aim to retain these benefits.

Under the level playing field of the baseline, superannuation funds are expected to face strong competition. However, the baseline reveals that there would be scope for superannuation funds to engage in unhealthy or wasteful competition. Alternative models should aim to reduce these undesirable features.

Importantly, the baseline acknowledges that members are likely to lean more heavily on other parties for advice, carrying with it the potential for conflicts of interest that could threaten the integrity of the superannuation system. Alternative models should adequately manage the risks caused by conflicts of interest.

The baseline is unlikely to cause instability or lead to systemic risk. Alternative models should do likewise.

Finally, although employer and superannuation costs are likely to be low under the baseline, members ultimately face high costs of allocation. Alternative models should aim to reduce search costs faced by members, such as effort and advice.

# 5 Assisted employee choice

#### **Key points**

- This chapter sets out the first of four alternative allocation models for a new default system.
- A model of assisted employee choice would consist of:
  - a non-mandatory product shortlist and associated information to nudge people towards a small set of good products
  - a set of protections to help employees choose from a broader set of products and reduce the risks of not making a choice.
- The product shortlist would reduce the complexity of choosing a superannuation product for a majority of employees by nudging them towards good products without going so far as to impose one by default. This would considerably reduce 'choice overload' and make disengaged employees more likely to make good choices.
  - The shortlist would comprise (indicatively) 4 to 10 products, selected through a rigorous administrative filter process run by an independent government body.
  - Simple information on the shortlisted products would be provided in a consistent format
    to help people choose between options and consider which product best meets their
    needs, with care taken in the presentation to avoid undesirable biases.
- Additional protections would help employees to compare products more broadly to identify
  one that best meets their needs, and reduce some of the material risks under active choice.
  - A system of voluntary product accreditation (a strengthened version of MySuper) would encourage funds to provide a 'no frills' product for employees who are not well placed to select specific investment options themselves.
  - A last-resort fund would hold the contributions of employees who do not make prompt choices until they have chosen a product.
- Relative to the baseline, the assisted employee choice model performs well against the assessment criteria and would:
  - significantly reduce the complexity people face and lead to more people choosing high-performing products that meet their needs
  - focus competition on product aspects of value to members, put downward pressure on fees and potentially curtail wasteful product proliferation
  - better align funds' interests with those of members
  - have lower search costs for many employees, partly offset by additional costs to funds and government associated with new regulatory structures.

The previous chapter described what unassisted active choice of superannuation products might look like: some employees may struggle to identify which product best meets their needs, may procrastinate and put off making a choice, or could be swayed by marketing or conflicted interests to choose a product that leaves them worse off in the long term.

This chapter presents a model of 'assisted' choice that combines active choice by employees with guidance and a set of protections (table 5.1). First, a shortlist of products would 'nudge' employees towards good superannuation products, supported by the provision of simple and comparable information on key features of those products (section 5.1). Second, a set of regulatory protections, comprising a voluntary system of product accreditation and a 'last-resort' fund, would help employees to compare products more broadly and reduce the risks of not making a choice (section 5.2). Compared to the baseline, this model performs well against the Commission's assessment criteria (section 5.3).

Table 5.1	Summary of key features of assisted employee choice		
Main design eleme	Design features		
Product shortlist	Employees are presented with a shortlist of (indicatively) 4 to 10 products, listed in random order.		
	These products are selected by an independent government body on the basis of being good products for a majority of employees, following a rigorous administrative filter process.		
	Employees remain free to choose any legally complying product that is not on the shortlist.		
Information on short products	Information on the shortlisted products is provided to employees in a consistent format to help employees choose between options and consider which product best meets their needs.		
	The information is simple and covers investment performance, risks and fees (with the specific metrics to be based on detailed consumer testing). Additional information on the products remains available to employees through other channels.		
Product accreditation	A government body administers a system of product accreditation to encourage funds to provide a 'no frills' product for employees who are not well placed to select specific investment options themselves.  Accreditation is similar to MySuper, but with stronger standards on fund scale and performance, and clearer processes for removing accreditation from non-complying products.		
	Accreditation is voluntary for funds. Employees remain free to choose any legally complying product, regardless of whether it is accredited.		
Last-resort fund	A low-cost fund is established to hold the contributions of employees who do not nominate their own superannuation product. The fund is tightly regulated and could be based on existing funds for lost accounts, or provided by the Future Fund.		
	This fund has a remit to encourage its members to select a product from another provider in the market. Once they do, members' balances are transferred to their chosen provider.		

# 5.1 A shortlist of products

The central feature of the assisted employee choice model is a shortlist of superannuation products. In essence, employees would be given a list of high-quality products to pick from, while retaining the option to nominate any other product in the market. The shortlist would be supplemented by information on the key features of those products to help employees make an informed choice about which product best meets their individual needs.

There is a strong body of evidence that shows that the way choices are presented and the way information is provided can have powerful impacts on people's choices. This evidence from behavioural finance has inspired the use of 'nudges'. Thaler and Sunstein (2009) defined a nudge as an aspect of the way that choices are presented that alters behaviour towards options that make people better off, without forbidding any options and making it easy and cheap for people to choose a different option if they wish.

A nudge is not the same as a default. While defaults can be a form of nudge, it is still possible to steer people towards particular options without any form of automatic assignment. Sometimes this will be preferable, especially where there are strong advantages in encouraging each individual to consider the available options, or there are concerns about potentially misleading or harming consumers through the imposition of defaults (Clark, Strauss and Knox-Hayes 2012, p. 142).

A shortlist of superannuation products would fulfil this definition of a nudge. The basic principle is that the choice 'architecture' is modified to simplify the set from which people can choose, and to steer them towards selecting a higher-quality product than they might otherwise — but without going so far as to impose a product chosen by somebody else as a default. Employees would remain free to nominate a product not on the shortlist — including a product sponsored by an employer or union — or to self-manage their superannuation. In this way, they must still make an active choice, but are assisted in the task.

The main benefit of the shortlist is that it would make it easier and simpler for employees to choose a good product that meets their needs — especially for those who have limited financial knowledge or would put little effort into researching products. Even employees who select randomly from the shortlist would be better off than choosing a bad product or making no choice at all, compared with the baseline of unassisted active choice (chapter 4). The shortlist approach also differs from the present system in that there is no compulsion to use the list, whereas today various instruments apply compulsion to many employees' choice processes.

Yet this shortlist will have costs. Which products make it on the list — and who selects them — would have a powerful influence on which products many employees choose. Accurate and comparable information can be difficult to provide, and may not reflect all product features that matter to everyone (though employees would remain free to seek

further information on the products from other sources). The costs and benefits are explored in greater detail in section 5.3.

# Which products should be shortlisted?

The shortlist would only contain products that have been assessed as being good options for the majority of employees on the basis of a 'heavy' administrative filter, with the selection criteria and process the same as detailed for the preferred default list in chapter 8 (each fund would also need to offer an accredited product, as defined in section 5.2). This would mean that each product would need to meet criteria for long-term net returns, investment approach, governance and other factors. Importantly, the stringency of the criteria will need to be adjusted such that the number of successful funds that appear on the shortlist is within an acceptable range (as described below).

Figure 5.1 provides an example of what the shortlist might look like on a standard choice form. When an employee selects one of the products on the list, an account with the relevant fund would be opened on their behalf to receive their superannuation contributions (by transmitting relevant information from the choice form to the fund and employer). This would result in lower transaction costs for employees compared with the current rules, whereby employees wishing to nominate a specific fund must already have opened an account with that fund, and must obtain a letter from the fund stating that it can receive contributions from their employer (ATO 2015b, p. 2). The new process would be facilitated by the centralised online service discussed in chapter 3, which would also allow employees to choose an existing superannuation account they already have.

The effectiveness of the shortlist will depend to a large degree on how many products are listed, the order they are listed in, and who compiles the list and on what basis. It will also hinge on what supplementary information is provided about the products to help people make a choice. This information should be unbiased and readily comparable across products. The Commission does not envision a shortlist without any supplementary information to assist employees.

To better understand how employees would use a shortlist and supplementary information in practice, the Commission has commissioned an experimental survey of the working age population (chapter 1). Among other things, this survey examined how people's choices were influenced by the length of the shortlist and the types of product information provided. The work is underway but not completed. The results will be analysed following publication of this draft report and incorporated in the Commission's final report.

Figure 5.1 Shortlist of products — example only

Employee to complete Choice of superannuation product	
I request that all my future super contributions be paid to (select one option only):	
☐ My existing superannuation account (Western Super)	
OR	
One of the following shortlisted products:	
<ul> <li>Northern Super − Super Saver</li> <li>ABC Super − Balanced</li> <li>XYZ Fund − Invest for the Future</li> <li>Southern Super − Aspire to Retire</li> <li>Investment Expert Super − Balanced</li> <li>JKL Fund − Balanced</li> <li>Super Duper − Nest Egg</li> </ul>	
Information on these products can be found below	
OR	
The APRA fund or retirement savings account I nominate (provide details below)	
Based on ATO (2015b, p. 5).	

# How many products should be shortlisted?

The length of the shortlist will bear on its effectiveness. Several studies have found that presenting too many options can overwhelm people and lead them to make poor choices (box 5.1). Such 'choice overload' may mean that a very long list of products is no more helpful than no list. However, evidence varies for how long is too long.

Restrictions on the number of options presented have been put forward as one way to reduce choice overload and help people to make better choices (Abaluck and Gruber 2011, p. 22; Ketcham, Kuminoff and Powers 2016, p. 2). In a review of the literature, Johnson et al. (2012, p. 490) suggested that four or five options is a reasonable initial value for a choice set, potentially with an option for people to see more options if they wish. Other reviews point to the importance of contextual and individual factors, noting that the amount of choice overload people experience depends on the complexity of the decision

and choice set, how certain people are in their preferences, and how much effort they are willing to put into the decision (Cherney, Böckenholt and Goodman 2015). Financial literacy is also likely to play a role.

#### Box 5.1 Evidence of choice overload in financial decisions

Behavioural researchers in the United States have found that asking people to select from long lists of financial products can quickly lead to them feeling overwhelmed, especially when they have lower levels of financial knowledge. In a well-known experiment, lyengar, Huberman and Jiang (2004, pp. 88-91) found that every additional 10 products on a list of retirement savings product options was associated with a 1.5 to 2 per cent fall in scheme participation, with participation rates falling fastest when more than 30 products were listed.

A separate study of superannuation product choices found that an increase in the number of options from 10 to 19 led to a jump in the proportion of employees who ended up in the default option from one fifth to one third (Morrin et al. 2012, p. 546). Other research has found that the more investment options people are presented with, the more likely they are to opt for the status quo (a product they already have) (Samuelson and Zeckhauser 1988, p. 8). In all these cases, adding more options appears to discourage people from selecting any of them.

There is also evidence that people struggle to make good choices when the number of options is large. In one study, researchers found that halving the list of investment options (from about 90) led to employees choosing options with significantly lower costs, which they estimated would generate large financial savings over time (Keim and Mitchell 2016). Similarly, research on health insurance has found that a high number of product options is associated with poorer-quality choices: people are more likely to select expensive products and overlook products that better meet their needs (Abaluck and Gruber 2011; Johnson et al. 2013).

However, shorter is not always better. Too few products could increase the risk of people selecting a product that does not meet their needs, or leave people more susceptible to framing effects (discussed below). It could also reduce welfare for people who would be better off under options that are not included in the set (Ketcham, Kuminoff and Powers 2016, p. 34).

The supply side of the market is relevant too. In the event that there is a moderate number of 'good' products, such that it is difficult to definitively classify some as better than others, artificially reducing the number could cut out products that are otherwise worthwhile. There is also a risk that a very short list could restrict competition between providers, depending on how frequently the list is changed (ASFA, sub. 24, p. 23).

Drawing together these considerations and the available evidence, it would appear that a shortlist should ideally contain somewhere in the range from 4 to about 10 products. Fewer than four would likely curtail choice too much; more than 10 would likely lead to choice overload for some employees and reduce the value in having a shortlist at all. The Commission expects to refine these bounds using the results from its survey, and is also asking participants for additional evidence that is relevant to this matter. Ultimately, the actual implementation of a shortlist would need to be preceded by consumer testing and/or trials to determine what works best in this specific superannuation context.

#### How should the list be ordered?

The order in which products are listed also matters. Psychologists have long recognised that the order in which people are asked questions has a detectable influence on their responses (Krosnick and Alwin 1987). In a well-known experiment, Benartzi and Thaler (2002, p. 1610) found that people were averse to picking extreme options when selecting from a set of investment portfolios ordered from low to high risk, to the extent that their preferred option among two alternatives changed when a third option was presented either to the left or right side of the pair.

In a context where all the products on the superannuation shortlist are 'good', their order should be randomised to remove any ordering biases. This approach is already used for election ballots and in other contexts (such as surveys). Randomisation would be relatively straightforward for an online choice form (as part of the centralised online service described in chapter 3), and the order could be re-randomised at regular intervals.

## What information should be provided?

Providing information on key features of the products on the shortlist would further help to nudge people towards choosing good products that suit their needs. <sup>19</sup> Some studies have found that people often fail to seek out information on financial products, even when it is easy to access, and thus providing it to them directly can lead to better choices (Kling et al. 2012). More generally, a review of research on financial education found that it is usually most effective when provided 'just in time' for people to make a decision (Fernandes, Lynch Jr and Netemeyer 2014).

Providing relevant product information alongside the choice form would reduce the search costs of employees finding this information themselves, and would make it easier for them to compare the products. Several inquiry participants supported government provision of basic information about the features and performance of selected products (CHOICE, sub. 31, p. 14; CMD, sub. 18, p. 8; IPA, sub. 17, p. 8). The consumer group CHOICE (sub. 31, p. 10) argued that its market research showed that 'many consumers had lost faith in the super funds or financial advisers to help them with decisions around superannuation'.

#### The amount and presentation of information matter

To be effective, information should be relevant, easy to understand, comparable, and sufficiently complete so that people can make the right choices — especially if they are

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<sup>19</sup> In principle, such information could be provided without a shortlist, though the products featured would need to be determined through a similar process (such as an administrative filter) — and since only a limited number of products could realistically be featured, such information would in any case be a de facto shortlist.

unlikely to seek information from other sources. Helpful (versus defensive) disclaimers should accompany the information to explain how it was sourced, where to find further information or assistance (such as on fund or government websites), and the need for employees to consider their individual circumstances.

Providing simple yet effective information is easier said than done. A large volume of complex information exists for individual superannuation products, and distilling this to the attributes that matter most will be difficult. Providing too much information risks confusing people or deterring them from reading it. People can be overwhelmed when presented with too many different attributes and tend to respond by using a single attribute to simplify their decision (Johnson et al. 2012, p. 495). There is also evidence that providing people with information on particular attributes of superannuation products (namely asset allocations) can lead them to make worse choices than had these attributes been omitted (Bateman et al. 2016b).

On the other hand, providing too little information may mean that employees are unaware of important product features that they care about. The Australian Securities and Investments Commission (sub. 41, p. 2) submitted that that 'being able to provide the right information which enables effective comparability of funds is of critical importance'.

The way that information is presented also matters. There is considerable evidence that decision making is subject to biases that arise from the way choices are framed (box 5.2). Some experts have even presented evidence that the way options are presented can have a stronger influence on people's investment decisions (in aggregate) than the underlying risk and return characteristics of the investments (Mitchell and Utkus 2004, p. 16). The literature offers evidence favouring a range of techniques to minimise biases, such as including graphs to aid decisions (Bhandari, Hassanein and Deaves 2008, p. 399), highlighting the consequences of each option (Keller et al. 2011, p. 382), and presenting a small number of information items for multiple products simultaneously to make it easier for people to compare specific attributes (Bateman et al. 2016a, p. 20).

#### Metrics for the shortlist

Taken collectively, the above evidence suggests that the information provided with the shortlist (that is, alongside the superannuation choice form) should err on the side of being simple rather than comprehensive. Additional information would remain available to employees through other channels. Funds would still be required to issue product disclosure statements and comply with other reporting requirements, and private-sector information (including product ratings and comparison tools) would be available (chapter 4).

### Box 5.2 Framing effects on decision making

Psychologists have long recognised that people have limited capacity for mentally processing information (Benartzi and Lehrer 2015; Mayer and Moreno 2003, p. 43). As a result, they may resort to heuristics (mental shortcuts), such as focusing on more salient information or using rules of thumb to simplify decision making (Kahneman 2011). This means that the way investment information is presented can influence the choices people make (Benartzi and Thaler 2007, pp. 92–94). However, these influences can be complex and difficult to predict.

#### Scale and time periods

Psychological experiments have shown that people are especially sensitive to how numbers are presented, and in particular the scale and time period. A common finding is that people appear more willing to take risk when returns are presented over a longer time horizon. For example, Benartzi and Thaler (1999, p. 377) found that survey participants said they would invest more of their retirement savings in shares — and thus were willing to accept more risk — when they were shown 30-year rates of return rather than 1-year returns. Other studies have found that people's willingness to accept a given risk can change depending on whether it is framed as a probability of success or of failure (Kahneman 2011), and that people are likely to take more risk when investment choices are presented graphically (Kaufmann, Weber and Haisley 2013, p. 325).

Another key research finding is that people tend to give more weight to fees when presented in dollar terms rather than percentages (Bateman et al. 2016a, p. 13). For example, in consumer testing for MySuper dashboards, many participants did not notice when the scale on an annual return graph was varied (from a maximum of 10 per cent to 20 per cent) (ASIC 2013, p. 32).

#### Anchoring and availability biases

There is evidence that people's responses to questions can be influenced by the presence of other numbers they have recently seen, even when these numbers are clearly unrelated (anchoring biases). There is also evidence for a tendency for people to use only the information in front of them when making a decision, while neglecting other relevant information that is not immediately to hand (availability biases) (Kahneman 2011).

#### Diversification

Framing effects have been shown to have a particularly strong impact on asset allocation decisions. In a widely cited study, Benartzi and Thaler (2001, p. 79) found evidence that, when presented with a number of investment options, people tend to allocate their assets evenly among them regardless of what those options are — which they term the 1/N heuristic. Others have found that when a large number of options are available, people tend to choose a subset and divide assets equally among them (Gerrans and Yap 2013, p. 1; Huberman and Jiang 2006, p. 763).

Bateman et al. (2016b, p. 60) presented experimental evidence that this phenomenon applies for pre-mixed investments, with participants tending to favour portfolios with more evenly sized shares of assets across categories, even when this comes at the expense of lower returns or higher risk. As a consequence, presenting information on asset allocation can distract people from focusing on the underlying risks and returns.

Designing simple metrics for superannuation products has been a long-running challenge, especially where the objective is to inform people who are relatively disengaged with superannuation or have low levels of financial literacy. Some stakeholders are of the view that existing disclosures do not make it easy for people to compare products across funds (for example, AIST, sub. 28, p. 4; ISA, sub. 40, p. 15). Bateman et al. (2016a, p. 7) argued that Australian regulators have tended to focus on how well consumers understand the information rather than whether it assists in decision making. They noted that research on simplified financial disclosures in the United States and European Union has also found that disclosures are not always easily understood by consumers and do not always lead to better decision making (Bateman et al. 2016a, pp. 2, 13).

Significant work has been done in recent years to develop product dashboards for MySuper (default) superannuation products, which were intended to make it easy for members to compare products offered by different funds, and thereby improve competition and transparency in the industry (Shorten 2013). However, these dashboards have been criticised by a number of parties (box 5.3), and it is unclear how many people use them when choosing between superannuation products.

Although universal agreement on the exact types and formats of information that should be provided is lacking, at a minimum, the Commission considers that it would be most helpful to provide indicators that cover longer-term investment performance (returns), risks and fees, as well as an indication of how well a product has performed relative to the industry average. The Commission's experimental survey presented participants with some of these types of information in the context of a shortlist (table 5.2). It is also requesting participants' views on relevant information to provide, and evidence to support this.

Ultimately, detailed consumer testing (including real-world trials) will be crucial prior to final design and implementation to better understand how people use the information and to refine the presentation.

Table 5.2	Product information used in the Commission's survey Hypothetical example only	
Label	Description	
Return	Gained X% a year (on average) over past 10 years	
Risk	Expect a loss in X out of 20 years	
Target	To increase balance by CPI + X% per year, over next 10 years	
Fees	Pay X% of account balance in fees per year	

### Box 5.3 **MySuper product dashboards**

MySuper product dashboards have been mandatory since December 2013. They are required to contain, in a prescribed format, information on:

- returns for each of the 10 previous financial years (where available)
- the return target over 10 years
- a comparison between the return target and actual returns for previous years
- the level of investment risk
- a statement of fees and other costs, measured in dollar terms for a \$50 000 account balance (ASIC 2014).

MySuper was introduced after a period of consumer and industry testing by the Australian Securities and Investments Commission. It found that consumers favour simple information, with returns presented graphically and fees customised to individual balances (ASIC 2013).

#### Fee disclosure

The fee metric used on MySuper dashboards has been criticised. Fee structures can differ significantly across funds, and so the reported dollar figure (for a representative \$50 000 balance) may not be a useful guide for members with differently sized balances. The Actuaries Institute (2016, pp. 1, 3) has recommended that dollar-value fees also be included for \$10 000 and \$250 000 balances, and that administrative and investment fees be separately reported.

#### Standard risk measure

The 'standard risk measure' used for MySuper dashboards — the likely number of negative annual returns over a 20-year period — was criticised by participants in the Commission's stage 1 superannuation study for not conveying the likely magnitude, path or timing of negative returns (PC 2016, p. 115). In a recent survey, participants displayed low levels of understanding of this risk measure (Bateman et al. 2016a, p. 14). The Australian Prudential Regulation Authority has noted that the standard risk measure was developed by the superannuation industry, and that it has been encouraging the industry to develop other measures to communicate risk (APRA, sub. DR111, p. 5 to PC 2016).

Some stakeholders have proposed alternative risk measures. For example, the Actuaries Institute (2016, p. 14) suggested reporting the number of years in which returns are likely to exceed a given benchmark (such as inflation plus 4 per cent). In experiments, participants have been observed to make more rational investment choices when returns are presented as a range or using probability-based descriptions, as opposed to describing risks as a frequency above or below a given threshold (as per the standard risk measure) (Bateman et al. 2016c).

#### Return graphs and warnings

A recent study surveyed people to examine how they use the return and fee disclosures on the MySuper dashboards (Bateman et al. 2016a). It found that while respondents switched between products fairly quickly when the fee differential changed, they were more reluctant to switch when short-term returns changed. This was the case regardless of the volatility of returns or how they were presented (graphically or in table format), though simplifying the return information led to prompter responses. The researchers suggested that their results may reflect the relatively complex presentation of return information on the dashboards (as a graph) and the prominence of warnings related to the uncertainty of future returns.

# Who should compile the shortlist?

An independent body, established by government, is best placed to select which products should be shortlisted (as described in chapter 3). This body would be an impartial arbiter. It would compile the shortlist by deploying a 'heavy' administrative filter (chapter 8).

While it would be possible to task a private-sector provider (such as a ratings entity) or individual employers with compiling shortlists, this could give rise to conflicts of interest. Commercial relationships between ratings entities and particular funds — and advisory activities undertaken by entities otherwise primarily involved in rating funds — are common enough today to suggest that, at a minimum, perceptions of conflict would arise. This does not, however, suggest that private ratings entities should have no role; simply that there must be a public-interest decision maker, lest the credibility of the process be damaged.

Inquiry participants generally supported a government-managed process. For example, the Financial Planning Association of Australia (sub. 29, p. 13) submitted that the body assessing funds should be independent of industry interests, and noted that there is a risk that private ratings entities would be captured by special interests that differ from the interests of employees. It argued that, instead, the government should provide fund comparison data that are at employees' fingertips when they make their choice (FPA, sub. 29, p. 12). Other participants also pointed to the risks of relying on privately provided information (for example, CHOICE, sub. 31, p. 10), or argued that 'public confidence would be stronger in a government-managed exercise' (AIST, sub. 28, p. 51).

The main risk with a government body compiling the shortlist is excessive risk aversion, resulting in only conservative products being listed. An additional risk is that of demands for compensation if one of the products underperforms or leaves members worse off (ASFA, sub. 24, p. 23; PwC, sub. 12, p. 6). It is likely that these risks could be significantly mitigated through the selection of qualified investment advisers to the body, through the structure of institutional or legislative arrangements, and by promoting clarity in the voluntary nature of the information given. The current system in Australia has for the most part successfully avoided the perception that the government guarantees positive returns, even where criminal activity has seen significant defrauding of superannuation investors.

A final consideration is how frequently the list is updated. Changing the list too frequently would be administratively costly (as the filter process would need to be re-run). On the other hand, changing it too infrequently could give some products an unfair competitive advantage over others and risk employees being guided towards products that no longer perform well. As discussed in chapter 3, the process should initially be run every four years. In the event that a product loses its place on the shortlist or fails to reapply for inclusion, and provided the fund remains legally compliant, the fund would not automatically lose its existing members (who remain free to choose a product from a different provider).

# 5.2 Other employee protections

While a shortlist should be of great assistance for many employees who would struggle to make decisions under unassisted active choice, the benefits would mostly accrue to those employees who act and select one of the products on the shortlist. The gap between knowledge and action will still arise as funds that do not make the shortlist will respond with more intense marketing efforts. And there is nothing in a non-mandatory approach like this to ensure that the utterly indifferent employee makes any choice at all.

This section discusses a set of regulation-based protections that aim to help employees to compare products more broadly — and ultimately select one that best meets their individual needs — while reducing the risks of not making any choice at all. These interventions are targeted at specific problems that an examination of the world of unassisted active choice demonstrated (chapter 4), including the complexity of comparing different products, asymmetries in information between funds and employees, and the risk that employees who fail to make any choice will forfeit their superannuation contributions.

These protections form part of the assisted employee choice model, and could apply across the superannuation market generally. They could be implemented separately or in combination. The details set out here are illustrative; ultimately, any regulatory change should only proceed if it offers a net benefit to the community. The Commission's final (stage 3) inquiry will consider that.

### **Product accreditation**

The difficulties that most employees would face in selecting a superannuation product under active choice would only be partly ameliorated by a shortlist. Those who wish to compare other products available in the market may still find it difficult to compare product features and performance, especially if they have limited knowledge, capacity or confidence to shop around.

The Commission sees merit in a product accreditation regime as a way of engendering a harmonised subset of simple products in the market. Accreditation would be voluntary for funds, and funds could apply at any time (though accreditation would be mandatory for funds seeking inclusion on the shortlist discussed earlier). Any product that meets a minimum set of standards could apply to be assessed by a regulatory body — in this case, the Australian Prudential Regulation Authority (APRA) — and given a stamp of accreditation. The criteria used to assess products would be very similar to those used to determine which products are on the 'minimum standards' list described in chapter 8.

The standards would specify a 'no frills' product that provides administration, investment and intrafund advice services. Each fund's product would contain a single diversified investment strategy (with funds permitted to offer life-cycle variations) and single fee structure for all members. But a specific asset allocation or investment strategy would not

be prescribed, leaving funds free to tailor their products to the needs of different types of members. Funds could use the accreditation in their marketing and promotional activities.

This regime would have many similarities to the current MySuper regulations, which are administered by APRA (table 5.3). The intention of these reforms was for a 'no frills' product with simple features that are easy to compare across funds (Australian Government 2011, p. 3). It was not intended to preclude anyone from using a more complex or tailored choice product, or from self-managing their own superannuation (Cooper et al. 2010, p. 10).

Table 5.3 Com	parison of MySuper and	product accreditation
Characteristic	Current MySuper authorisation process	Product accreditation in the Commission's model
Similarities		
Accumulation product features	Administration, investment, intrafund advice	Administration, investment, intrafund advice
Investment strategy	Single diversified strategy or set of life-cycle strategies	Single diversified strategy or set of life-cycle strategies
Fee structure	Single fee structure that applies to all members	Single fee structure that applies to all members
Exit fees, switching fees, and buy–sell spreads	Levied on cost recovery basis	Levied on cost recovery basis
Commissions	Prohibited	Prohibited
Number of accredited products per fund	One <sup>a</sup> (including any life-cycle variations)	One (including any life-cycle variations)
Governance standards	Funds must be likely to comply with trustee obligations	Funds must be likely to comply with trustee obligations
Differences		
Need for accreditation	Funds must obtain MySuper authorisation to receive default contributions	Voluntary for funds (but mandatory for funds seeking shortlisting)
Accreditation process	One-off licencing, with ongoing monitoring	Formal ongoing monitoring of fund performance following accreditation, with funds required to self-report against criterial
Investment performance	Funds must report return and risk targets, but no specific performance standard	Products that persistently underperform (over multiple years) relative to pre-stated targets lose accreditation
Fund scale	Funds must demonstrate that the scale of the fund does not disadvantage members relative to members of other MySuper products	Funds must regularly demonstrate, and have independently verified, that fund scale is not an impediment to performance
Insurance	Life cover and total and permanent disability cover must be provided on an opt-out basis	No requirements, but any insurance must meet minimum regulatory standards (chapter 3), and details must be clearly and accessibly disclosed

 $<sup>{</sup>f a}$  In some circumstances, funds can offer different administrative fees to members who are employees of large employers. b Self-reporting is to be backed up by independent auditing by, or on behalf of, APRA. Sources: Australian Government (2011); PC (2016).

Inquiry participants generally supported some kind of accreditation process. Some favoured the retention of MySuper under alternative models, with the process strengthened to include greater protections for members. For example, the Financial Services Council proposed an enhanced MySuper approval process to strengthen the safety net for members who are relatively disengaged. It envisioned that this would involve funds obtaining authorisation on an ongoing basis from APRA, based on a 'multifactor "member outcomes" assessment' that considers scale, fees and longer-term net investment returns (FSC, sub. 38, pp. 21–22). The consumer group CHOICE (sub. 31, p. 3) argued that 'any consumer choice needs to occur with an appropriate safety-net in place'.

APRA (sub. 33, p. 2) also supported a stronger MySuper process, submitting that there is 'merit in legislating both stronger authorisation requirements and a broader member outcomes assessment in lieu of the current scale test'. APRA noted that there has been considerable variation in net returns and fees across MySuper products, and that some products have fallen well short of meeting their net return targets.

While many elements would be similar between the existing MySuper process and the product accreditation in the Commission's assisted employee choice model, there would be some key differences (table 5.3). Specifically:

- accreditation would not be a legal requirement for funds to accept default contributions
   since there are no defaults in this model but a voluntary process
- while funds would still need to demonstrate (and independently and regularly verify)
  that the fund's scale does not impede investment performance, funds would also lose
  accreditation if their product persistently underperforms (over multiple years) relative
  to pre-stated targets
- there would be a more formal process for monitoring the performance of accredited funds: funds must demonstrate on an ongoing basis (for example, annually) that they continue to meet the minimum standards; those that do not would lose accreditation.

The common thread linking all the accreditation standards is that assessment would be relatively objective. While attributes such as investment performance and fund scale can invite a degree of subjectivity, the standards for these would be based on 'negative tests'—that is, funds must demonstrate (and independently and regularly verify) that they have not adversely affected members through poor investment performance or scale. Framed in this way, the standards would not risk punishing otherwise sound funds affected by short-term market movements. Negative tests also avoid imposing barriers to new entrants seeking accreditation, as funds lacking a performance history cannot have breached the test.

This system of product accreditation would offer several key benefits (section 5.3). It would make it easier for relatively more engaged employees to compare products, since the product design would be harmonised across funds (which would lead to lower search costs). Accreditation would offer protection to fund members who are not experienced or confident investors and simply want a 'no frills' product without having to pick specific

investment options themselves. Importantly, funds would have the ability to tailor accredited products to different types of members (for example, in terms of investment strategy), thereby giving members scope to seek out a product that meets their individual needs and personal circumstances.

As accreditation would be voluntary for funds (with the exception of funds seeking inclusion on the shortlist), a balance needs to be struck between setting high standards and making it an attractive proposition for funds to seek accreditation in the first place. Complying with the standards would have a cost to funds, though in many instances this cost would be offset by the additional members and reputational benefits that would flow from offering an accredited product.

Any accreditation process introduces the complication of how to deal with members of a fund that loses its accreditation. Given that employees are responsible for choosing their own product under this model, any process that leads to them being automatically moved to another fund risks leaving some worse off and would be difficult to implement. Instead, funds that lose their accreditation should be required to communicate this fact clearly and immediately to members of the affected product (who may then choose to switch to an accredited product with a different fund).

#### A last-resort fund

Some employees may fail to nominate a product under active choice (chapter 4), and this risk may remain despite the other protections discussed above. A 'last-resort' fund would act to protect these employees so their superannuation contributions are not forfeited. This fund would be established to hold the contributions of these employees until they select a product themselves (in most cases they would be new entrants to the workforce who do not already have a superannuation account).

The last-resort fund would effectively be a default, but not in the usual sense of the term: it would simply provide a temporary holding account. It would not compete with other funds for members, and members would not be able to switch into the last-resort fund once they have already chosen a superannuation product. Importantly, the fund would have a remit to encourage its members to select a product from another provider in the market. It would safeguard a member's superannuation contributions until they have exercised choice, and then transfer their balance to the product chosen.

PricewaterhouseCoopers proposed such a fund. It submitted that:

If there was just one default fund which was considered the most basic, lowest cost, no frills and possibly a government-run fund, designed to catch the least number of default employees as possible, then it may just encourage more people to actively select a more suitable default fund. (PwC, sub. 12, p. 2)

Similarly, the Association of Superannuation Funds of Australia (sub. 24, p. 22) argued that the Australian Taxation Office (ATO) may need to operate a facility of last resort where an employee fails to nominate a superannuation fund under an active choice model. Indeed, researchers have argued that providing an unattractive default option can be a way to encourage people to make their own active choices, and may be useful when people have highly heterogeneous preferences (Carroll et al. 2009, p. 1671).

The last-resort fund could be based on existing eligible rollover funds (which hold member balances rolled over from lost or inactive accounts). These typically offer a very basic product, with low fees and returns, low-risk investments and no insurance. The regulator (APRA) would stipulate what services must be provided and the fees that can be charged, and require that the fund help its members make an active choice.

An alternative would be for such a fund to be operated by the ATO, potentially in conjunction with the Future Fund. The Commission seeks participant views on suitable institutional arrangements for a last-resort fund.

# Should marketing practices be further regulated?

The baseline — unassisted active choice by employees — would be characterised by significant marketing and promotional activity by superannuation funds and other parties, such as related financial institutions and financial advisers (chapter 4). Some of these marketing activities would benefit employees by helping them to identify products that suit their needs. However, this marketing effort would come at significant system-wide cost, and much will reflect efforts by funds to retain members or attract new members from other funds (a zero-sum game). Employees may find it difficult to assess the accuracy of the information or whether advice is subject to conflicts of interest.

Marketing and promotional practices are already subject to regulation. Consumer and financial services laws make misleading and deceptive conduct unlawful, and a suite of financial regulations require funds to measure and disclosure their fees and costs in a prescribed manner. Further, financial advice is subject to regulation, and workplace laws prohibit employers and unions from coercing employees into joining a specific superannuation fund.

Given the extent of marketing activity likely to prevail under any system of active employee choice, government resources will need to be directed towards monitoring behaviour in the marketplace and enforcing existing rules. These rules are generally broadly defined, with regulators and courts having discretion in how they are applied.

However, it is not currently illegal per se for a fund to give benefits to a prospective member as an incentive to choose the fund (ASIC, sub. 41, p. 4). Under any alternative model that encourages active marketing, stronger regulator powers may be necessary to protect member balances in the event that funds (or related parties) offer short-term benefits to prospective members that are unrelated to the superannuation product itself (such as consumer goods or discounts on banking or loan products).

That said, limits on such behaviour can be difficult to specify and enforce, and would come at the risk of prohibiting behaviour that may be beneficial to members (for example, poorly crafted limits could rule out legitimate payments to members in the decumulation phase, such as payments reflecting an accrued tax benefit). At this stage, the Commission is requesting participants' views on whether additional restrictions on marketing practices would be warranted and, if so, what form such restrictions should take.

#### 5.3 Assessment against the baseline

The Commission's model of assisted employee choice contains several components. While these could be implemented separately, this assessment is based on the joint implementation of all components.

#### Member benefits

Some benefits will vary across members

The model would improve member benefits by making it easier and simpler for employees to choose a good product that meets their needs. The benefits would be significant — and apply broadly, since by definition there are no 'default members' in the model — though their form and extent would likely vary.

- Low-engagement members, who lack the motivation, knowledge or confidence to research and select products themselves, would be significantly less likely to choose a bad product (based on limited or no research) if they opt to select a product from the shortlist.
  - The shortlist would make the process of choosing a product simpler, while significantly reducing the likelihood of members being unduly influenced by conflicting advice, confusing information, brand loyalty or marketing. As such, it is expected to have a significant positive impact on these members' balances over the long term.
  - While the shortlist would likely reduce the proportion of employees that fail to make any choice at all, employees who do end up in this situation would have the protection of the last-resort fund, and so would not be forgoing their employer contributions.
- Moderate-engagement members, who would do some comparison of available products under the baseline, would benefit from significantly lower search costs.
  - Those who use the shortlist would benefit from the objective and straightforward information provided, and would likely experience a significant reduction in the amount of time and effort they need to dedicate to the choice process.

- Those who undertake broader research would particularly benefit from product accreditation, which would lead to harmonised products and help members to identify a product that best meets their individual needs which could increase engagement and consequently reduce the need to pay for financial advice.
- Both the shortlist and accreditation process would reduce scope for confusion and cognitive biases, and would make it less likely that members choose products with overly conservative investment strategies or that persistently underperform.
- *High-engagement members*, who possess sufficient expertise and confidence to choose products from the wider market, could use the shortlisted and accredited products as a benchmark to assist with evaluating other products.

As noted earlier, the Commission has initiated a survey to further explore some of the impacts of a shortlist and information provision on members' decision making. The results of this survey will be incorporated into the assessment of this model in the final report.

### Other features will apply more broadly

Other benefits will extend across the spectrum of member engagement. The shortlist could make the inflow of new members to shortlisted funds more stable, relative to the baseline, as these funds would not be as dependent on marketing efforts to persuade prospective members to join. This could give the funds slightly greater capacity to invest in ways that maximise long-term returns, given they would likely have lower liquidity needs.

However, there are some risks to the benefits of the model being realised. In particular, there could be low rates of participation in the accreditation or shortlisting processes by funds. When a product loses accreditation, members in that product could be adversely affected if they do not re-evaluate their situation. And, even if there are high rates of participation in the accreditation process by funds, the existence of an underperformance standard based on meeting pre-stated targets could lead to some funds setting relatively conservative targets.

There is a narrow area of risk that the shortlist reduces the incentive for some employees to seek out a product better suited to their individual needs. This could be a particular concern for people with atypical characteristics (such as irregular work patterns or insurance needs) that might be better off seeking professional advice or undertaking their own research. However, these risks would also arise from default products (and thus are common to all the Commission's models and the current arrangements), and employees would remain free to select a non-accredited or non-shortlisted product, seek financial advice or self-manage their superannuation.

Importantly, the protections set out in this chapter to assist employees to choose a product would be supplemented by the broader architecture of prudential and consumer laws that apply even in the baseline (chapter 4). Nevertheless, none of these protections will *guarantee* that all employees make good choices. Under any model where employees are

free to choose a superannuation product, some will inevitably make bad decisions (chapter 1). But the number who do is expected to be materially lower under this model of assisted employee choice compared with the baseline.

### Competition

### Competition would be more focused on member outcomes

A shortlist could substantially change the nature of competition in a world of active choice. Instead of competing directly in the market for members' contributions, some of funds' efforts would be directed to competing for the market — that is, to be on the shortlist. One direct effect of this may be to somewhat reduce expenditure on marketing by funds that are shortlisted, although these funds would still likely advertise to promote their status on the shortlist, and non-listed funds would likely devote increased effort to marketing.

Product accreditation would also facilitate rivalry between funds by enabling members (and intermediaries) to more easily compare product features and performance across funds. Improved comparability can level the playing field between funds and reduce information asymmetries between funds and their members. This would make it easier for members to switch funds and thus keep competitive pressure on providers. It can also put downward pressure on fees — as, of course, can prohibitions on certain fees within accredited products. For example, there was general agreement among participants in the Commission's stage 1 study that the MySuper reforms have increased competitive pressure on funds (PC 2016).

While both shortlisting and accreditation would lead to funds changing existing products or introducing new products that meet the required standards, both interventions would also likely divert the focus of competition away from product proliferation and providing irrelevant product features. Relative to the baseline, this would reduce the number of members who are in highly customised products with multiple investment or insurance choices (which many such members may neither need nor value). Further benefits could arise from the effects of shortlisting and accreditation on fund consolidation, in large part due to scale-related criteria in the assessment of products.

Importantly, the benefits of accreditation will hinge on its uptake by funds, which is uncertain. Any accreditation system carries the risk of stifling innovation or imposing higher compliance costs that do not lead to commensurate benefits — either to funds or to members (who could ultimately be left worse off in the long term). This can discourage funds from seeking accreditation in the first place, thereby defeating the intent of the reform

### The market would remain highly contestable

The fact that only a very limited number of products would be included on the shortlist could pose a barrier to new funds entering the market (or existing funds developing new products). Equally, it could provide a guide to new funds for how to gain early acceptance by members.

Shortlisting could also create barriers to exit if it means that funds must continue to accept new members while they are listed. These barriers have the potential to reduce competitive pressure and innovation, especially if the list is not reviewed regularly.

However, this too would not necessarily lead to bad outcomes. Indeed, the shortlisting process handled sensibly would strengthen competition between funds to maximise long-term member benefits and reduce costs. All funds would be eligible to participate in the process, and so the market would remain contestable, provided that the shortlisting process is re-conducted at regular intervals. This would give non-listed funds an incentive to improve their product offering to become listed (including through mergers to increase fund scale), while the constant pressure of losing a place on the list would give funds already on the shortlist an incentive to keep constantly improving in areas relevant to the filter, in anticipation of the next contest.

Finally, the competition impacts of a last-resort fund (or funds) are expected to be small, regardless of whether it is government owned or not. The fund would be designed to capture only the small proportion of employees who fail to make any choice (even with the assistance offered by the other interventions), and it would have a requirement to guide its members towards the products of other providers. Any differences in regulatory treatment for this fund, or an implicit government guarantee, are not expected to unduly favour it over other providers in the market.

### Integrity

The integrity of the interventions set out in this chapter will reflect both the efficacy of their design and the performance of the regulator. Integrity will also depend on how well rules are enforced — and, especially, whether funds that fail to meet the required standards lose their accreditation or place on the shortlist. Institutional aspects are important too, as discussed in chapter 3. Specifically, government involvement in shortlisting can bring with it a risk of choosing products that are too conservative, and the quality of the decision making will ultimately depend on the quality of the individuals comprising the responsible body.

As noted above, the shortlist may reduce the incentive for funds to undertake expensive or wasteful marketing (including on features unrelated to long-term member interests). Risks of collusion and other gaming are probably minimal with a voluntary listing and a process involving tens if not hundreds of funds, along with a well-developed private-sector ratings

system as exists today in Australia. However, to the extent that they might apply, chapter 8 considers these risks along with ways to mitigate them further.

More generally, both shortlisting and product accreditation could reduce scope for employees to make bad decisions on the basis of conflicting advice or interests. This would be due to a combination of direct prohibitions on commissions and by providing a form of benchmark to help employees to evaluate other products or advice. However, employees would still be required to actively choose a product, and thus some risk of being persuaded or coerced into a particular product would largely remain under this model.

### **Stability**

The assisted employee choice model is expected to have minimal if any adverse impacts on the stability of the superannuation system. Sudden large-scale movements in balances or members are highly unlikely, and the shortlisting process would be unlikely to result in excessive levels of market concentration. Funds that lose their position on the shortlist would not automatically lose their existing members. Those that lose accreditation would not face enforced loss of members either, though would be required to inform members in their default product that it is no longer accredited, and thus may experience some outflows of members to other funds.

### System-wide costs

The assisted employee choice model will likely see material reductions in search costs for some employees, mostly arising from spending less time and effort on choosing a product, and less money on financial advice, relative to the baseline. All employees will experience lower transaction costs with the ease of using the centralised online service to select an existing account (compared with the need to provide documentation to the employer, as in the baseline) or to select a new product from the shortlist. In addition, employees who fail to exercise choice would not be forfeiting their superannuation contributions as they would be placed in the last-resort fund.

This model may also result in a reduction in some marketing activities by funds, with a corresponding reduction in marketing costs. However, significant marketing effort will still likely occur across the superannuation system.

At the same time, the model would impose some (but not large) system-wide costs that are not present in the baseline. Funds would incur some additional costs, primarily in the form of administrative costs in seeking accreditation or shortlisting and compliance costs in designing products that meet the requirements of these systems. There may also be costs associated with collecting and reporting the supplementary information for the shortlist. While some of these costs may initially be significant, they would fall over time once structures have been established and funds have adjusted their internal processes.

Government would also incur costs in administering a shortlist and accreditation system. These include the cost of establishing a body to compile the shortlist, as well as the ongoing regulatory costs associated with monitoring the behaviour of funds. And there would be the possibility of calls for government compensation in the event that one of the shortlisted funds fails — a very unlikely event given the current level of high prudential scrutiny. All of these regulatory costs are likely to be similar in magnitude to those that would be incurred under the assisted employer choice model set out in chapter 8.

Further costs to governments would be incurred in establishing a last-resort fund (though some of this cost would be recovered from its members) and in establishing and running a centralised online service and/or centralised clearing house (as discussed in chapter 3). However, over the long term, the model is expected to have significantly lower costs associated with raising revenue to fund Age Pension liabilities, relative to the baseline.

The impacts on employers are likely to be small relative to the baseline, where employer costs are already very low. The risk of employers being found in breach of their superannuation obligations because an employee has failed to nominate a product will be reduced due to the last-resort fund.

#### **Overall assessment**

The assisted employee choice model described in this chapter reflects what the Commission considers to be a workable alternative to a system of defaults — it is a collection of information improvements and regulatory interventions that could be realistically implemented. It is also expected to lead to significantly better outcomes overall than the baseline (table 5.4).

#### **DRAFT FINDING 5.1**

Relative to the baseline, the assisted employee choice model would:

- significantly reduce the complexity employees face in choosing a product and lead to more employees choosing high-performing products that meet their needs, thereby increasing member benefits
- focus competition on product aspects of value to members, put downward pressure on fees (through greater product comparability) and likely curtail wasteful product proliferation
- better align funds' interests with those of members
- support a stable superannuation system
- have lower search costs for many employees and very low costs for employers, but with government and funds incurring additional costs associated with regulatory structures.

Table 5.4	Assisted employee choice model: summary
Criterion	Assessment
Member benefits	The shortlist would make it simpler and easier for employees to compare products and select a suitable product. It would also reduce the probability of employees relying on irrelevant or conflicted sources of information.
	Product accreditation would make it easier to compare products from a wider set of providers and make decisions simpler.
	The shortlist and accreditation would make it more likely that employees exercise choice and the last-resort fund would reduce the penalty associated with not exercising choice. But some risk remains that employees fail to exercise choice or choose a good product.
	Employees would not be forced to choose accredited or shortlisted products and would remain free to choose other products.
Competition	Improved product comparability from accreditation would put downward pressure on fees. Accreditation would also encourage funds to provide a 'no frills' product for members who are not well placed to select specific investment options themselves.  Accreditation may curtail wasteful product proliferation in the market as a whole.
	Shortlisting could raise barriers to entry, though would not be inefficient given the process would be contestable and repeated.
	Accreditation and shortlisting can potentially reduce innovation, and the associated compliance costs can discourage funds from participating.
Integrity	The integrity of the interventions would reflect both the efficacy of their design and the performance of the regulator and shortlisting body.
	Both shortlisting and product accreditation could reduce scope for employees to make bad decisions on the basis of conflicting advice or interests.
Stability	Sudden large-scale movements in balances or members are unlikely, and the model is not expected to result in excessive levels of market concentration.
System-wide costs	Search costs are likely to be materially lower for many employees.  There will be additional compliance costs to funds, which would be offset by a reduction in marketing expenditure (though marketing activity would likely remain significant).
	There are relatively small monitoring and enforcement costs to government.

#### **INFORMATION REQUEST 5.1**

In terms of a shortlist of superannuation products, what evidence is available on the size of the list that would best facilitate the majority of employees to choose a fund that meets their needs?

What specific information should be included alongside such a shortlist to help employees to choose between products? In what format should the information be presented? What evidence is there for how the metrics would assist employees to make decisions?

What institutional arrangements would best suit a last resort fund? Should it be managed by existing eligible rollover funds or the Future Fund?

Under a system of active employee choice, what would be the costs and benefits of prohibiting funds or related parties from offering prospective members a short-term benefit that is unrelated to the superannuation product? What specific form should any such prohibitions take?

# 6 Fee-based auction

### Key points

- A fee-based auction would require funds to compete for default fund status by out-bidding each other on member fees.
- A reasonable presumption underpinning this model is that, over time, variation in member fees explains a significant amount of variation in net returns. This suggests that an auction

   which would drive fees down — has the capacity to lift long-term net returns.
- Using an auction to select providers of default superannuation products is not without precedent: Chile uses this approach to select its default providers.
- But there are some potential risks.
  - Funds may bid an unsustainable fee structure, in the hope that the greater scale economies from new members eventually decrease costs. Funds may also seek to upsell a higher fee service at a later date or raise fees not committed to under the auction.
  - Non-fee aspects of performance such as member services and investment management may suffer. Investment performance may suffer due to funds avoiding or decreasing exposure to higher-cost illiquid investment opportunities, like infrastructure.
- There are many well-tested levers in the design of auctions available to address these risks. These levers are complemented by existing superannuation regulations that also work to mitigate these risks.
- To test the scope for a fee-based auction to meet members' needs, the Commission designed a prototype auction for assessment against its five model assessment criteria.
- The auction assessed performs well against the baseline. Relative to the baseline:
  - member benefits would be higher, due to the likelihood of reduced fees
  - competition would be enhanced in the area of fees (and fee transparency)
  - integrity would be assisted due to the auction's simplicity and accountability mechanisms
  - stability is unlikely to be compromised because the model would not lead to excessive concentration of funds or volatile movement of members and assets
  - system-wide costs are expected to be slightly lower, mainly due to lower search costs for members.

The fees charged by Australian superannuation funds have been the subject of much policy debate. The Financial System inquiry (FSI) (Murray et al. 2014) compared the fees charged in Australia with other countries, and considered whether superannuation fees are higher due to a lack of competitive pressures.

Some participants to the FSI argued that simple fee comparisons with other countries are misleading. These participants highlighted that:

- the high returns achieved in Australia are partly due to superannuation funds' willingness to invest in higher cost asset classes, such as direct property, infrastructure, hedge funds and private equity (ASFA 2014; AustralianSuper 2014; Chant Deloitte 2014). Costs are also driven by the provision of legislated and expected member services (FSC 2014). ASFA (2014) argued that in international terms, Australian defined contribution members are paying fees consistent with members of similar funds overseas
- some of the costs incurred by superannuation funds are unique to the Australian system and outside their direct control, such as the costs from adjusting to recent regulatory reforms (Deloitte 2014)
- other countries have different approaches to fee disclosure, making it difficult to directly compare fees in Australia with those charged elsewhere (Chant West 2014a).

While the FSI agreed that features of the Australian superannuation system contribute to higher costs, it nonetheless concluded that fees are still too high given the scale of the system, and that Australian funds could lower fees without compromising net returns.

Since the Australian superannuation system is several times larger than [defined contribution] systems overseas, Australian funds could be expected to have lower fees after accounting for differences in features. A major concern of the Inquiry, shared by the Super System Review, is that the Australian system as a whole has been unable to realise the full benefits of scale. (Murray et al. 2014, p. 102)

Researchers at the Grattan Institute also argued that superannuation fees in Australia are excessive, and reported evidence that suggests long-term net returns are primarily driven by fees (Minifie, Cameron and Savage 2014). On this basis the Grattan Institute argued that policy makers should consider selecting default superannuation providers using a fee-based auction.<sup>20</sup> They cited Chile's experience with an auction for selecting the default superannuation provider, which has reduced fees for default members.

A number of criticisms are levelled at fee-based auctions, including that an exclusive focus on fees would drive funds to adopt a passive, low-cost investment strategy, reducing member returns (FSC, sub. 38, p. 29; ISA, sub. 40, p. 54; AustralianSuper, sub. 19, p. 3). The debate over the merits of a fee-based auction is thus linked to the broader debate over whether gross investment returns are largely market driven, and the relative merits of active and passive investment management (PC 2016, chapter 6).

<sup>&</sup>lt;sup>20</sup> In a subsequent paper Minifie, Cameron and Savage (2015) said that for some asset classes, a sole focus on fees may not give investment managers sufficient incentive to perform.

### Box 6.1 The relationship between fees and returns

There is an extensive literature that investigates the relationship between fees and net returns. Overall, there is evidence that fees are a significant predictor of net returns, because *on average* it is not possible to outperform the market (Johnson et al. 2015; Jones and Wermers 2011). Researchers at Morningstar compared the net returns of active and passive investment managers in the United States, and concluded:

... actively managed funds have generally underperformed their passive counterparts, especially over longer time horizons, and experienced high mortality rates ... failure tended to be positively correlated with fees (that is, higher cost funds were more likely to underperform or be shuttered or merged away and lower-cost funds were likelier to survive and enjoyed greater odds of success). Fees matter. They are one of the only reliable predictors of success. (Johnson et al. 2015, p. 1)

This of course does not preclude some individual fund managers from outperforming the market average by pursuing active management strategies (associated with higher fees), including by investing in alternative asset classes (PC 2016, pp. 126–128).

In the case of the Australian superannuation system, there is evidence that fees *are* a primary determinant of net returns. As noted, the Grattan Institute (2014) found evidence that, on average, Australian funds that charge higher total (investment and administration) fees deliver lower net returns once fees are accounted for. Their analysis suggests that a fund with fees 1 percentage point below the average fee could be expected to generate net returns about 1.4 percentage points above average.

The Grattan Institute's findings are consistent with some other studies. Basu and Andrew (2014) drew on data from 2004 to 2012 and found a (statistically) significant and negative relationship between gross returns from Australian superannuation funds and expense ratios (incorporating both investment and operating expenses, which are the primary determinants of investment and administration fees). They found that a 1 per cent decrease in fees is associated with a 0.1 per cent increase in gross returns (and by extension a larger increase in net returns). Drew, Stanford and Veeraraghavan (2002) examined the investment performance of Australian superannuation funds between 1991 and 1999, and found that higher investment fees were associated with lower net investment returns.

Chant West (2014a) responded to the Grattan Institute's report by arguing that the higher investment fees charged by the ten largest MySuper products are justified by higher returns. This conclusion is based on evidence that these ten products, which had allocations in unlisted assets between 10 to 36 per cent, had higher average annual investment returns over a 15-year period to 2014 compared to a passive benchmark portfolio. The Chant West measure of returns is not adjusted for administration costs (and therefore does not represent net returns as defined in this report).

Other studies have found that while higher fees lead to higher returns, these higher returns may simply be compensating investors for higher risk. Ainsworth et al. (2016) found that Australian superannuation funds with higher investment fees usually have higher allocations to riskier asset classes, which are more expensive to manage. The study found evidence that funds that charged higher investment fees produced higher net returns than the cheapest funds; however, the most expensive funds did not realise significantly higher net returns once risks were taken into account. Similarly, Cummings and Ellis (2015) found that some Australian superannuation funds realised returns from illiquid investments (net of investment costs) that compensated for the non-diversifiable risk (such as liquidity risk) that the investments contributed to the investment portfolio.

There are two reasons why it is worthwhile exploring a fee-based auction as a competitive allocation model. First, there is evidence that variation in member fees explains a significant amount of variation in net returns (box 6.1). Second, realising economies of scale would allow the superannuation system to achieve lower fees without diluting net returns. While both points may be contested, they are not without merit.

As such, the Commission has explored whether a fee-based auction could be designed to meet members' needs (summarised in table 6.1). The chapter first considers the key design features of an auction (section 6.1), then proposes an auction model for assessment (section 6.2), and finally assesses that model against the baseline using the criteria outlined in chapter 2 (section 6.3).

Table 6.1 <b>Ke</b>	y features of the auction model				
Main design element	Design features				
Pre-qualification	Products must meet a set of minimum standards relating to investment strategy and member services.				
	Funds must prove that they can manage expected inflows of default fund members.				
Bidding format	First-price sealed-bid, and potential best-and-final-offer stage.				
Assessment criteria	Administration and investment fees.				
Number of winners	One to five.				
Allocation of members	Sequential allocation.				
Transparency	Information to be withheld only if its publication can be reasonably expected to have commercially adverse consequences for the bidder.				
Monitoring and enforcement	Terms of appointment (and termination) specified in a contract.  Account for winners' performance in future auctions.  Option to shorten default period in case of one winner.				

#### **Elements of auction design** 6.1

A typical auction requires bidders to compete with each other on a single, price-based metric. The seller elicits higher and higher bids from participants until all but one participant has withdrawn and the good is allocated to that last remaining bidder at a price equal to their most recent bid. In a well-designed auction, the final price approximates the highest bidder valuation.

In a fee-based default superannuation auction, funds would bid for the right to receive the flow of new default superannuation members for a designated period of time, based on the fees they would charge members. The process aims to minimise costs for new default members by allocating the right to the fund or funds with the lowest fees.

### There are fundamental challenges in designing an auction

Selecting default superannuation products using a fee-based auction would present several risks. Some of these risks are not unique to auctions, arising in other allocation processes.

### Unsustainable loss leading and raising other fees

Funds could use a short term 'loss leading' strategy, whereby the winning fund bids a fee below near term cost. A fund could pursue this strategy in the hope that the greater scale economies from new members eventually decreases its costs. If this strategy proves unsustainable, the fund's members are likely to incur higher costs over time as funds try to correct for losses by reducing services and/or increasing fees.

Another possibility is that a fund pursues this strategy with the intent to upsell a higher fee service at a later date (ASFA, sub. 24, p. 13). The scope for such short-term behaviour should be considered in an assessment of the auction's performance in delivering member benefits.

There is also a more general risk that the winners of an auction could later raise fees not committed to under the auction. Providers of superannuation products levy a number of fees, including administration, investment, insurance, switching, exit, activity and advice fees. Member fees can also be built into asset prices and buy-sell spreads.<sup>21</sup> AustralianSuper commented:

... if a tendering system considers only administration fees, then investment management fees would increase and defeat the intentions of the tendering process to keep costs down. (sub. 19, p. 3)

Another risk is that fees increase following a merger between a winning fund and a non-participant.

### Non-fee aspects of performance suffer

The auction's primary focus on fees could reduce non-fee aspects of performance. In an effort to provide the lowest fee possible, funds may fail to compete on areas of performance such as innovation, the suitability of the investment approach and the quality of member services (ASFA, sub. 24, p. 3; CIFR, sub. 7, p. 5; First State Super, sub. 26, p. 6; FPA, sub. 29, p. 10; FSC, subs. 38, 49, pp. 27, 1; IFAA et al., sub. 13, p. 5; ISA, sub. 40, p. 54; Vision Super, sub. 4, p. 9).

<sup>21</sup> A buy-sell spread is the difference in the buy and sell unit price of an asset.

In commenting on tender processes generally, The Association of Superannuation Funds of Australia (ASFA) argued:

To reduce costs to a minimum, all non-core services for members such as [income stream offerings, advice, and website functionality] may be reduced or dropped altogether. In addition, it is also very difficult to build concepts like innovation into a tender process. This combined with a focus on price would restrict innovation in the sector. It would also drive homogeneity in default funds. (sub. 24, p. 13)

The Retail Employees Superannuation Trust (REST) warned that an excessive focus on fees would see the investment approach suffer.

Any over emphasis on lower investment management costs favours a short term investment philosophy requiring greater liquidity requirements and the adoption of a cheaper passive indexing strategy with the prospect of lower returns. (sub. 23, p. 12)

### Bids may not fall as far as costs might allow

An auction would enhance the pressures on funds to reduce fees. In the current system, for-profit funds have twin incentives, having to consider the interests of both shareholders and members when setting fees and meeting costs. And while non-profit funds do not have to provide a profit to shareholders, this means that they may have relatively weaker incentives to reduce costs (and with them fees). Running a competitive auction in such an environment helps to discover how far funds, otherwise not fully under pressure to reduce fees and costs, can do so.

Achieving competitive outcomes however relies on funds being able to make reasonably confident estimates of the value of winning the auction. Funds need to estimate the likely number of new default members in the designated default period, and the value of their contributions into the future. This valuation also depends on how many choice members will choose the winning product as a result of the quality signal that winning sends, and how many members will leave the product. To estimate the net present value of future contributions, funds will have to forecast future costs and investment returns, among other things.

Information used to produce these estimates can be sourced from funds' own knowledge — large, well-established funds will have good internal estimates of the value of default members; and those working presently across multiple industries will be particularly well-placed. Bids by competing funds and any information provided by the seller will also be informative. On the latter source, offering estimates to the less well-informed bidders may assist the auction to operate at its most competitive, but comes with the risk that the estimates prove misleading and bids prove unsustainable.

The key takeaway from these observations is that while the auction should set out terms that maximise the opportunity for price discovery, it cannot be expected to produce a fee level fully reflective of costs, both present and future. This is because it cannot match bidders' own knowledge nor ameliorate the effect of valuation uncertainty. Nevertheless,

auction design should take into account that more information means more confident bidding and a better result for members.

### Bids may be subject to collusion

A risk in an auction is that funds collude to coordinate behaviour such that the fees offered do not reflect a competitive outcome. It can, however, be difficult to identify whether funds are colluding or not. Funds have more information about their costs than the auctioneer (an information asymmetry), and variation between funds may in any event not be large. Moreover, some strategic behaviour can appear collusive but in practice is not.

In general, the key risk factors for collusion are multiple rounds, repetition over time, relatively few competitors and multiple winners. Having multiple rounds provides scope for signalling, and repetition over time allows more sophisticated signalling across auctions. Further, coordination is easier the fewer the number of competitors. Agreements are also easier to reach when units can be allocated across bidders, as is the case when there are multiple winners (Chan, Laplagne and Appels 2003).

While some of these risk factors are present in a fee-based auction — for example, the auction would be repeated over time — the Commission considers that the overall risk of collusion is low. Numerous participants are likely given the large number of active funds and the dependence of many on new member inflows. Further, the market would not be captive to any collusive agreement, because all members can still exercise choice at any time. More generally, reputation risk, as well as current fiduciary and statutory obligations (supported by various regulations), are likely to discourage such behaviour. The Commission is also not aware of any international evidence of collusion in similar processes, like the Chilean auction and New Zealand tender.

### Designing an auction: what are the risk mitigant levers?

Auction design is critical to achieving the auction's objectives, and for helping to address the above identified risks. Policy makers have a number of levers when it comes to auction design, many of which are well-tested in other markets or auction processes. The levers cut across the three main stages of an auction — pre-auction, conduct during the auction, and post-auction — and include the:

- pre-qualification stage
- bidding metric
- bidding format
- governance arrangements for the auction process
- number of 'winners' identified
- frequency with which auctions are held

monitoring and enforcement mechanisms and rules that apply after the auction.

Notably, these levers would not operate in a vacuum: much of the existing policy and regulatory framework for products and funds — which also work to further mitigate these risks — would apply (chapter 3).

### Pre-qualification stage

Prior to bidding, most auctions require participants to meet certain conditions in a pre-qualification stage. Typically bidders must provide basic information about themselves and their services by lodging an expression of interest to compete in the auction. In New Zealand's 2014 tender process, participants had to, among other things, undergo stress testing of their systems and processes to ensure they could deal with expected member volumes and be operational when allocation began (appendix B). By excluding funds that clearly fail to meet minimum standards, pre-qualification can reduce the time spent assessing bids and enhance the integrity of the process.

In the case of superannuation, demonstrating the capacity to absorb and manage a large influx of new members annually would be an essential pre-qualification requirement. Governance standards of an order higher than the regulator's requirement would also seem essential given the need to possibly deal with a higher level of public exposure. A level of reserves that avoids dependency on finance-as-you-go management of administrative costs, including the costs incurred from receiving an influx of new members, is also important.

Pre-qualification can also commit bidders to minimum levels of service and other aspects of performance not directly accounted for in the bidding stage. As such, it could potentially help to address the risk under an auction that non-price aspects of performance will receive little-to-no attention.

A number of inquiry participants supported using MySuper, or a strengthened version of it, as a pre-requisite for default products (AIST, sub. 28, p. 33; CIFR, sub. 7, p. 7; IFAA et al., sub. 13, p. 8; Kinetic Superannuation, sub. 45, p. 4; Mercer, sub. 15, p. 3; PwC, sub. 12, p. 3; WSSA, sub. 11, p. 2).

Other proposals include limiting the set of default providers to those funds that:

- successfully retrieve unpaid Superannuation Guarantee contributions (Australian Super, sub. 19, p. 3)
- provide unbiased advice and transparent performance indicators (Centre for Market Design, sub. 18, p. 5)
- satisfy regulatory audits (Kinetic Superannuation, sub. 45, p. 4)
- are not in the lowest 10 per cent of performers on net returns (AIST, sub. 28, p. 44).

A pre-qualification stage has its own risks — for example, unknowingly excluding new participants by designing for the known participants — and so must be designed carefully.

### The bidding metric

Another choice in the design of an auction is which fees should be the basis for bidding.

Inquiry participants did not provide views on which fees are most suitable for an auction. In Chile, the right to provide default superannuation products is auctioned on the basis of administration fees. In Chile, these fees cover administration, distribution, and internal investment management costs (Chant West 2014b). They do not include investment fees charged by external fund managers, which (along with the investments themselves) are separately regulated and scrutinised in Chile. In the Chilean system, the fees that are the subject of bidding form a majority of total fees on average across all pension providers (FSC, sub. 49, p. 1).

The Commission considers that fees forming the bidding metric should account for a large proportion of the total charges levied on members. This better ensures that the auction materially benefits members. Fees should also have scope to fall from their current levels, either because they well exceed efficient costs, or because there is scope for funds to reduce costs over time.

AustralianSuper (sub. 19, p. 3) highlighted the risk that targeting administration fees leads to the winners of the auction raising investment fees (a 'waterbed' effect). Another risk is that in seeking to cut costs, funds reduce aspects of performance valued by members. For example, setting investment fees in an auction could result in funds adopting a lower cost investment strategy, which may come at the expense of diversification and long-term net returns if the fund develops an investment portfolio with less exposure to potentially higher-yielding asset classes that are higher cost and/or require more active management. There is an inevitable trade-off between including a given fee in an auction or not: excluding it could lead to a waterbed effect, while including it could reduce aspects of product quality. Both risks may be mitigated through a well-designed pre-qualification stage, and contract obligations to lock in agreements.

### The bidding format

The bidding format is arguably the most fundamental design element of an auction. A vital consideration for the choice of format is the nature of the asset being priced. In the case of superannuation, unlike many other assets, the asset being sold is impermanent (a number of years access to default members); and more importantly the seller has an ongoing interest in the welfare of the members who make up the asset. Unlike the sale of telecommunications spectrum or asset privatisations, the asset stewardship is in effect shared. Leaving aside the degree to which this might be a legal matter, it is clearly going to be a matter of interest to policy-makers and the winning fund alike that the offers are delivered.

There are two high-level bidding formats: open and sealed. Each have their own variations (box 6.2). Broadly, an open format is one where competition is more direct — bidders

observe each other's bidding in real time and the result is revealed to the bidders and the auctioneer simultaneously. A sealed format involves bidders submitting a single bid to the auctioneer, who then has control over how information is disseminated. It may also provide the auctioneer more flexibility to negotiate multiple winners via a best-and-final-offer stage.

#### Box 6.2 **Bidding auction formats**

### Open formats: English and Dutch

An **English** auction is the well-known ascending open-cry format, common to real estate sales. In the regular case the price is raised until one bidder remains and the good is sold to the last remaining bidder at their last stated price. A fee-based default superannuation auction that uses the English format would require bidders to bid so long as the current bid is above their 'threshold' fee (the lowest fee that would ensure their expected return is non-negative).

The **Dutch** format is the reverse of an English auction. In the regular case the price falls until a bidder accepts an announced price and pays that price. There is no dynamic competitive bidding; the format relies on the bidder with the highest valuation submitting the first and only bid. For a default superannuation fee-based auction, the Dutch format would involve the fee starting at some reserve level (potentially zero) and being raised until a bidder accepts a fee level. Some initial public offerings (IPO) have used a variant of the Dutch format to determine the market clearing price for newly-issued company stock (for example, Google's initial public offering in 2004 took such a form).

#### Sealed formats: First-price sealed-bid and Vickrey

A first-price sealed-bid format requires bidders to submit a single bid to the seller. The highest bid wins and pays that bid. This would look much the same in a default superannuation fee-based auction (aside from the winner being the lowest submitted bid). This format is used in the United States Forest Service timber auctions, where large portions of publicly owned timberland are auctioned to private companies for logging.

A Vickrey is a second-price sealed-bid format in which the bidder that makes the highest bid wins but pays the next highest bid. This would also look much the same in a default superannuation fee-based auction, with the exception that the winner would charge the second lowest bid. Examples of second-price auctions appear to be rare, however, examples cited in the literature include stamp auctions and more recently online eBay auctions where bidders are able to utilise proxy bidding.

Sources: Athey, Levin and Seria (2011), Ausubel and Milgrom (2005), Chan et al. (2003), Luckling-Reiley (2000), Weinberg (2004).

#### Responsible body and transparency

As discussed in chapter 3, the responsible body should have an understanding of members' needs and an obligation to act in their best interests. Practically, this means the auctioneer should be independent and free of any interests in the participating funds. It also means they should be accountable, and have no ongoing regulatory role, lest there be an incentive to favour a fund that offers some form of regulator advantage.

However, it is worth noting that this design element is of less importance in a typical fee-based auction than other models (such as a multi-criteria tender). This is because the allocation process is a function of a single, objective metric, reducing the scope for interference in an efficient allocation by the auctioneer.

Where not at risk of misleading bidders, more information flows — within and across auctions — are desirable given they decrease uncertainty and increase bidding confidence. Therefore, the process should be as transparent as possible to foster participant confidence and thereby greater participation. A high degree of transparency will also promote public trust in the process. However, there may be information that would reasonably be expected to have commercially adverse consequences for the bidder. It is important to balance the confidentiality needs of funds against the preference for transparency, as reflected in the Commonwealth Procurement Rules:

The need to maintain the confidentiality of information should always be balanced against the public accountability and transparency requirements of the Australian Government. (Department of Finance 2014, p. 21)

It is also important to note that the superannuation industry is already highly regulated with respect to transparency, with regulator datasets and product disclosure statements going into significant detail, particularly on fees and expenses. Given that Chile's auction process publishes unsuccessful bids, it would equally be reasonable for this feature to be included in Australia should we adopt such a process.

#### Number of winners

The auction could have a single winner or multiple winners. Restricting the auction to having a single winner would ensure that default members are in products of equal quality. On the other hand, there are potential benefits to having multiple winners. More of the existing stock of default members will benefit as each winning fund extends their winning product to their existing default members (chapter 3). Having multiple winners also increases the probability for any one fund to win, which would encourage participation. Further, multiple winners spreads the distribution of contributions which reduces the risk of dominance by a few big players in the longer run but reduces the participant's confidence in forecasting the inflows secured from being one of potentially many winners. Having a known band of potential winners (one to five) allows a reasonable confidence interval for that assessment.

### Frequency

As discussed in chapter 3, there are risks associated with the process being too frequent or too infrequent. Frequent auctions may increase the risk of a short-term approach to investment, and would increase costs for participating funds and the Government (Mercer, sub. 15, p. 6; ACTU, sub. 34, p. 10). Further, as explained above, running the process more frequently could increase the risk of collusive agreements being maintained if only a few

funds are regularly participating (seemingly an unlikely prospect with over 100 MySuper products). On the other hand, if the process is held many years apart, excessive industry concentration could harm competition in the long term. The auction process also reveals useful information, which is another argument for greater frequency.

### Monitoring and enforcement mechanisms

Another consideration in the design of an auction is how the winners will be kept to their winning fees and any other commitments they make in the auction process. Also important is guarding against the risks that the winners raise other fees, or reduce effort in non-price aspects of performance. The relationship between a winner of an auction and its default members — and therefore the risk that funds fail to meet their commitments — can extend well beyond the relevant default period.

There is a range of measures already in place that would regulate the conduct of the winners of an auction. These measures include trustees' fiduciary duties, statutory obligations under the Superannuation Industry (Supervision) Act 1993 (Cwlth) (SIS Act), and various provisions in competition and corporations law such as the dishonest conduct, inducing persons to deal, and misleading or deceptive conduct provisions. More generally, self-enforcing mechanisms such as the incentives created by reputational risk would motivate winning funds to meet their commitments.

However, while these measures play an important role, they would be insufficient to ensure winning funds meet all of their commitments. The auction process would need to include specific measures for this purpose. Options include the following.

- Accounting for performance in subsequent auctions, for example, precluding a previous winner from competing through the pre-qualification stage in a subsequent auction if it reneged on its past commitments.
- Regulatory mechanisms, such as a licensing regime for default fund providers with ongoing monitoring and reporting requirements, with the threat of removal of default status and potentially loss of default members if there is non-compliance. The Chilean Superintendence of Pensions receives reports from funds that outline fees and charges, enabling it to scrutinise the fees of default funds. Alternatively, the commitments made by default providers could be confirmed in a voluntary code of conduct or memorandum of understanding.
- Contracts that specify fees and service levels, and outline consequences for failing to meet these commitments. A contract could require winners to self-report against their commitments on an ongoing basis.

Unlike the supply of other products and services, the provision of a superannuation product is a long-term proposition and subject to various market forces that are outside the control of trustees. These factors may need to be taken into account in the design of mechanisms to ensure performance following an auction, without undermining system credibility.

### 6.2 The auction model considered for assessment

The Commission has designed a prototype auction for assessment. The auction would provide the winners with access to the flow of new default member contributions over the designated default period (and beyond if default members stay with the winning fund). As outlined in chapter 3, any competitive allocation mechanism, including an auction, should initially be held every four years.

The auction would be administered by an independent panel, constituted by government. The panel would advise the relevant Minister on which fund or funds should be selected for default status, with this advice made public. The Minister would be free to accept or reject the advice, although the reasons for any departure from the panel's recommendations would also be made public.

The model for assessment consists of three main stages.

- Pre-qualification stage participants lodge an expression of interest to compete in the auction. This stage limits participation in the auction to those products and funds that meet certain criteria. Participants must commit to a minimum level of service and other aspects of performance not directly accounted for in the bidding stage.
- 2. *Bidding stage* participants bid against one another in a first-price sealed-bid auction. The panel would have the right to conclude this stage by asking participants to submit a 'best-and-final-offer'. The winning offers would be formalised in a contract, and (if there are multiple winners) default employees would be sequentially allocated<sup>22</sup> across winning funds.
- 3. *Performance monitoring stage* the winning providers would self-report against the commitments made in their offers (formalised in a contract that applies for the duration of the default period). Providers that materially breach their commitments during the default period would lose default status.

### **Pre-qualification stage**

The pre-qualification stage is intended to filter out funds and products that are clearly unsuitable to winning default status. To pass the pre-qualification stage funds and products must meet minimum conditions.

Funds must prove that they can safely handle expected inflows of default fund members. As such, the assessment panel would assess funds on factors such as stability, liquidity, regulatory compliance, transparency and governance arrangements. The assessment panel

<sup>22</sup> Under a model of sequential allocation, each default fund takes a turn in being allocated a new entrant default member, with the process (including the order of allocation across funds) being repeated indefinitely. This model results in an even allocation of default members across winning funds.

should also be satisfied that winners have sufficient capital to pay for the resources needed to accept large inflows of new members.

Products should be balanced across capital growth and income assets, and would be required to limit fees not included in the bidding stage to cost recovery. The pre-qualification process should also include a performance filter: funds that underperform for five or more years across their investment products relative to a benchmark on long-term net returns would not qualify. To facilitate market entry, performance on past returns need not be confined to superannuation products: performance history could come from a similar investment product. Bidders without a performance history in the Australian superannuation system could be assessed based on their relevant performance in offshore markets.

To reduce the risk that an auction achieves low fees at the expense of other aspects of performance, participants would also be required to meet minimum member service standards in the following areas (chapter 3):

- administration and member engagement tools
- communication materials and intrafund advice
- quality of record keeping system
- transparency of fees and performance.

The pre-qualification process for funds and products would be similar to a strengthened MySuper authorisation process (discussed further in chapters 5 and 8). APRA (sub. 33, p. 2) has argued there would be merit in lifting the bar for MySuper by introducing 'stronger authorisation requirements and a broader member outcomes assessment'.

The Commission considered whether, instead of imposing minimum standards, funds could offer whatever service levels they want, with the panel then scoring each fund's service bundle and assigning a basis points penalty in the bidding stage to funds with relatively low service scores. This approach would facilitate competition between funds on aspects of member services. On the other hand, it could also lead to gold plating of member services. Regardless, it would be difficult to ensure objective and consistent evaluation of bids, short of the auction becoming a multi-criteria tender, and a rule would need to be developed for converting the service level score into a basis points penalty in the bidding stage. The Commission is seeking feedback from participants on whether a fee-based auction can be designed to facilitate second-order competition between funds on non-fee aspects of performance, such as member services.

### **Bidding stage**

### The bidding metric

The bidding metric would incorporate both administration and investment fees.<sup>23</sup> Together, these fees account for more than half of the total charges levied on MySuper members (APRA 2017c), and some research suggests there is scope for them to fall from current levels (Minifie, Cameron and Savage 2015; Murray et al. 2014). As such, accounting for both fees would be expected to deliver material benefits to members, and help to drive down costs and fees over time. Accounting for a large part of the total fee base also reduces the risk that the winners shift costs to other fees and charges (the waterbed effect).

The process for submitting bids should be designed carefully to ensure that the process cannot be gamed and achieves outcomes that meet default members' needs. The particular fee structure that is bid (such as the mix of fixed and variable fees) can result in a different overall fee burden for different account sizes. The panel should bear in mind that funds are bidding for the right to provide a default product to new workforce entrants, and therefore reward funds that set low fees for low account sizes, at least in the near term. However, to provide funds with flexibility, the panel should not rule any particular fee structure in or out.

While including both administration and investment fees reduces the risk of the waterbed effect, it increases the likelihood that winning funds adopt a lower cost investment strategy. For example, funds may avoid or reduce exposure to illiquid investment opportunities such as infrastructure, which may otherwise have increased long-term net returns. The Commission considers this risk in its assessment of the auction model in section 6.3.

#### The bidding format and transparency

A first-price sealed-bid auction format is likely to be the best fit. There are three benefits to using this format. First, it better allows for multiple winners. An open format produces a result that appears more 'final'. Whereas, under a sealed format, a best-and-final-offer stage could be used to produce multiple winners. Second, it may better encourage participation relative to other formats. This is because funds would face less risk in revealing sensitive information in the auction process to other funds (as the size of incremental bids in an open format can be informative in and of itself), particularly information that may put them at a disadvantage in the choice market if they are unsuccessful. This increased participation should transfer to more competitive bidding.

Administration and investment fees are defined in s. 29V(3) of the SIS Act. Administration fees relate to the administration or operation of the fund and investment fees relate to the investment of assets. These fees include costs incurred that are not otherwise charged as a buy-sell spread or a switching, exit, activity, advice or insurance (non premium) fee.

And last, a sealed-bid format also minimises the scope for collusion (though as explained above the risks of collusion are low in any case). The Commission is seeking feedback on the particular bidding format used.

There is also the question of whether bids should be released to the public. As explained in section 6.1, there are benefits for public trust and bidding competiveness from more transparency, but this needs to be balanced against the commercial sensitivity for funds. The principle of only withholding information if it can be shown to be reasonably expected to have commercially adverse consequences for the bidder should apply. The Commission is seeking further feedback on the optimal level of transparency.

#### Number of winners and best-and-final-offer

The auction is designed such that it could produce a single winner or multiple winners. As mentioned above, the key benefit of multiple winners is that more of the incumbent stock of default members will benefit, as each winning fund extends their winning product to their existing default members. Multiple winners also spreads the distribution of contributions, reducing the risk of dominance by a few big players in the longer run, although this is considered remote in any case. While having one winner reduces the risk of collusion, this risk is considered low (as detailed above).

The mechanism for acquiring multiple winners will be through a carefully managed best-and-final-offer stage. In particular, the panel would have the discretion to provide the opportunity for up to four of the most competitive funds to match the fee of the lowest bidder. The final decision on how many funds are able to match the lowest bidder would depend on the number of participants; if participation is low then fewer funds would be given the opportunity.

If there are multiple winners, the government would sequentially allocate employees across winning products. This approach, used in New Zealand, would impose a lower burden on employers and employees than if they were required to choose.

## Performance monitoring stage

The following mechanisms would increase incentives for the winning bidder to keep their commitments made during the auction process.

• Contract with ongoing communication and disclosure regime. The commitments made by the winning bidder would be confirmed in a contract, which would apply in the default period. Winners would need to transparently report against their core standard requirements on an ongoing basis. The contract would provide a reference for considering whether a past winner has kept their commitments, and would outline processes for managing the exit of underperforming funds. Ultimately, the relevant Minister would be responsible for enforcing the contractual obligations of successful funds.

- In the event that a fund has its default status revoked mid-term, its default members would be notified, and unless they opted to remain with the fund, would be sequentially allocated across the remaining default providers. If there is only one default provider, the default period would be truncated and a new auction would be held
- Accounting for past performance in future auctions. As part of the pre-qualification stage, any past auction winners would be excluded from progressing further if they materially fell short of previous commitments. For example, a winning fund may fail to provide the quality of member services promised in a past pre-qualification stage, or may seek to charge much higher fees than committed to under the previous auction. As already noted, products provided by funds that consistently underperform on long-term net returns would be excluded in the pre-qualification stage.

These mechanisms would be reinforced by existing measures, including trustees' fiduciary duties, statutory obligations under the SIS Act, and various provisions in competition and corporations law (see above).

The risk of fee increases following a merger between a winning fund and a non-participant would be collectively addressed by the contract and current regulatory measures. Default members who stand to lose from a merger would be protected by the SIS Act, which requires that bulk transfers of members to successor funds be made in the best interests of members. As discussed in chapter 3, a formal framework that requires fund trustees to give genuine consideration to merger proposals in the context of member interests would also need to be considered.

In the event that a default provider fails to win a future auction, it would be free of its contractual obligations. The provider would then have more flexibility to change its fees and conditions, which may not best meet the needs of existing default members. Existing regulatory measures would provide some protection for default members. To help keep members informed, the results of subsequent auctions would be made publicly available (chapter 3).

### 6.3 Assessment of the model

The Commission has assessed the proposed auction model against its five assessment criteria: member benefits, competition, integrity, stability and system-wide costs (chapter 2). In doing so, it has drawn on a range of evidence sources, including submissions from inquiry participants, conceptual analysis, literature on mechanism and auction design, and outcomes from other sectors and countries.

#### Member benefits

Member benefits are best met when funds have incentives to maximise long-term net returns and allocate members to products that meet their needs (chapter 2).

#### Outcomes under the auction

The auction would create strong incentives for funds to lower their fees, potentially boosting net returns. Importantly, the inclusion of both administration and investment fees reduces the risk that competition occurs on one type of fee, only for others to be raised.

At the same time, competition on fees could increase incentives for funds to adopt a low-cost passive approach to investment. Funds would have incentives to passively manage within an asset class (such as tracking an equity index instead of actively choosing listed equities), and to avoid or limit exposure to higher cost asset classes (such as illiquid investment opportunities like infrastructure and unlisted property). These incentives would be strengthened by the inclusion of investment fees in the bidding metric.

The impact of passive investment management within asset classes on long-term net returns is unclear. As noted in the introduction, there are disparate views on this issue, and it remains a source of ongoing debate. It is also important to consider the role that current regulatory arrangements would play in conditioning the behaviour of funds. In commenting on concerns that funds would resort to low-risk, low-return investments, Kinetic Superannuation argued:

If this is correct it means that the fund's directors and management would have knowingly adopted a strategy in contravention of its statutory covenants of best interests and balanced investment as well as the fund's investment governance and risk management frameworks. This critique does not consider the regulatory environment within which the bidding fund operates. The fund's reckless abandonment of quality and compliance controls and service standards, in addition to its investment and best interests covenants, or even its adoption of pricing manipulation or bidder collusion, amounts to a repudiation of a fund's governance framework and invites exposure of its directors and managers to legal liability. (sub. 45, p. 3)

On the other hand, lower exposure to illiquid investments could reduce diversification in default product investment portfolios, potentially reducing long-term, risk-adjusted net returns. Industry Super Australia highlighted a working paper by Cummings and Ellis (2011) that suggests greater exposure to alternative illiquid assets has contributed to increased risk-adjusted net returns for not-for-profit funds in Australia:

The outcomes delivered by not-for-profit funds is due to their 'members first' culture, and the fact they have invested a higher proportion of their members' savings in illiquid assets (such as nation building infrastructure, property and private equity) which deliver superior long-term returns, and lead to greater capital formation. (sub. 40, p. 11)

However, Cummings and Ellis (2011, p. 24) noted that their finding 'may be specific to this time period [2004–2010] and does not guarantee that funds with illiquid portfolios will always outperform funds with more liquid portfolios'. Others have also argued that there are difficulties in drawing conclusions about the long-term performance of alternative asset classes:

For many alternative asset classes, the quality and duration of the empirical data on assets and managers is not sufficient to draw conclusions about the potential for profitable active management. Despite recent dramatic trends in institutional investing, little is known empirically about the performance of alternative assets over long business cycles. (Ang, Goetzmann and Schaefer 2010, pp. 69–70)

Further, in a later version of their paper (published in an academic journal), Cummings and Ellis (2015, p. 473) concluded that 'taking account of risk, there is no evidence of outperformance for funds with higher allocation to these [illiquid] investments'. However, the authors acknowledge that as long as the returns from illiquid asset classes continue to at least reflect the non-diversifiable risks they introduce to portfolios, then there will be diversification benefits to the portfolio as a whole and a better risk-return trade-off.

As for other aspects of member benefits, the pre-qualification stage reduces the risk of low fees coming at the expense of member services. Another important aspect of member benefits is that employees are allocated to products that meet their needs. With a single winner, there is a risk under the auction that some members will not be suited to the product offered — one size may not fit all. While this risk can be mitigated with multiple winners, the winning products would be expected to be very similar, and there is still no certainty that any one individual will be allocated to a fund that fully meets their needs.

### Assessment of the auction relative to the baseline

The auction is expected to perform better than the baseline on member benefits. The baseline carries risks to member benefits, due mainly to poor employee decision making arising from cognitive constraints, behavioural biases and inadequate information (chapter 4). While the auction could reduce diversification across asset classes through lower exposure to illiquid investments, relative to the baseline, member benefits would be promoted by reduced fees and thereby higher net returns. In the end, putting young disengaged members in a low-cost, passive growth investment may not be an unreasonable approach.

### Competition

The auction should foster competition that drives innovation, cost reductions and more efficient long-term outcomes for members (chapter 2).

#### Outcomes under the auction

Competition for access to default members in the auction would potentially be strong. Notably, a well-designed auction that effectively addresses the risk of collusion does not necessarily require a large number of competitors to generate sufficient competitive tension. Rather, in many circumstances it should be sufficient for the number of competitors that are capable of winning the auction to exceed the number of winners. It would be important however to consider the impact of the number of winners on incentives to compete — too many would dilute the pool of new entrant default members, reducing the intensity of competition. And the competitive tension from having nine winners out of ten participants is likely to be much lower than where there is four winners out of five participants. While ongoing participation would depend on the integrity of the process and the costs of bidding, these issues can be addressed through careful auction design.

The focus of competition under the auction is on member fees. Including administration and investment fees in the bidding metric opens up competition to a broader set of funds than if fees covered only one of these measures. This also creates strong incentives for funds to innovate to find lower cost ways of providing both administration and investment services.

The auction process could also affect competition in the broader market for superannuation products. One way this could occur is through the winning fund and its fee structure providing a performance benchmark for other funds and choice members and their advisers. However, the lack of historical success in encouraging member engagement makes this at best an uncertain proposition, as does the experience in Chile, where funds that have not competed for the default market have maintained much higher administration fees (FSC, sub. 49, p. 1).

The auction could also affect competition in the broader market by altering market structure or creating barriers to entry. Some participants were concerned that a competitive allocation process would lead to excessive market concentration (APRA, sub. 33, p. 3; FSC, sub. 38, p. 15). APRA said:

... significant industry consolidation may result in much higher levels of industry concentration, potentially removing the incentive for the remaining, much smaller number of, large incumbent funds to vigorously compete under the default allocation model. (sub. 33, p. 3)

The auction would likely help facilitate some market consolidation. There are currently 115 MySuper products, and some MySuper providers may seek to merge with each other if they lose access to new entrant default members for four years (albeit they would still retain access to the legacy job churn component of the current default member market).

To the extent there is some market consolidation, this is unlikely to substantially affect competition. As highlighted above, some stakeholders have even suggested there is room for industry consolidation (APRA, sub. 33, p. 3; Chant West 2015; Minifie, Cameron and Savage 2014; Murray et al. 2014). Fewer products and competitors could even provide benefits, including improved productive efficiency and greater competitive pressure on upstream providers of superannuation services.

#### Assessment of the auction relative to the baseline

The auction would provide a marginal improvement to competition over the baseline. Competition for choice members under both the auction and the baseline would be highly contestable, with strong rivalry between funds. The *nature* of competition however, particularly with respect to default employees, would differ. Under the baseline there is scope for superannuation funds to engage in unhealthy competition, including wasteful marketing expenditure (chapter 4). While this same risk exists outside the auction process, the nature of competition *within* the process is mainly focused on fees.

### Integrity

The auction should assist integrity in the selection and delivery of default superannuation products, and the behaviour of superannuation funds more broadly (chapter 2). Three factors warrant particular attention: the potential for the allocation process to be manipulated, including by collusion among auction participants; the integrity of the agent assessing bids; and the strength of accountability and transparency mechanisms to ensure funds are held to account for the outcomes they deliver.

### Outcomes under the auction

There is a relatively low risk of manipulation of outcomes under the auction. The panel is unlikely to be able to distort the allocation given the objectivity of the process, and the potential for collusion is low given the factors discussed in section 6.1.

Ensuring winning funds meet their commitments during the default period is another important issue. This is enforced primarily via a contractual obligation, and the potential truncation of the designated period or exclusion from future processes. While breaches may be obvious in some cases, disputes may be more difficult to resolve in cases where the fund has followed the 'letter' but not the 'spirit' of the commitment. The resolution of disputes regarding the outcome of the process, and public trust more generally, are well supported by maximising transparency subject to commercial considerations.

### Assessment of the auction relative to the baseline

Overall, the auction could perform better than the baseline against the integrity criterion. There is an onus on the panel to get its advice to the Minister right in order to build public trust over time. The risk that the assessment panel fails to objectively and robustly assess bids is countered by the relative simplicity of the auction. The auction also reduces the scope for exploitative behaviour that can occur in the presence of compulsion and

complexity under unassisted active choice. Last, the accountability and transparency mechanisms of the auction are likely to be more effective in holding funds to account than unassisted active choice.

### **Stability**

The auction should not create instability in the superannuation system that leads to significant systemic risks. To this end, the auction should not lead to: excessive concentration in the superannuation product market or upstream supplier markets; excessive and volatile movement of members and assets between funds; or funds focusing only on short-term outcomes (chapter 2).

#### Outcomes under the auction

The auction is unlikely to require an excessive movement of funds, or lead to excessive concentration in the superannuation product market. To the extent there is some market consolidation, this would be unlikely to compromise stability. As highlighted above, some stakeholders have suggested there is room for industry consolidation (APRA, sub. 33, p. 3; Chant West 2015). Some consolidation could even improve stability if it leads to a more efficient allocation of resources.

While the auction may result in some funds adopting a short-term focus (such as through an unsustainable loss leading strategy), which would have implications for member benefits, it is unlikely to lead to funds ceasing operations abruptly, and as such is unlikely to have wider implications for system stability.

#### Assessment of the auction relative to the baseline

Neither the auction nor the baseline pose a material risk to stability. Both scenarios are unlikely to lead to excessive market concentration, given the Commission's definition of a new default member. Nor would either scenario promote a short-term focus that compromises stability.

## System-wide costs

Minimising system-wide costs involves minimising the total costs across members, employers, funds, and government (chapter 2). An assessment of this criterion requires an examination of whether the auction is likely to increase or reduce the costs on each of these four parties, the likely materiality of the change, and a judgment on the overall cost impact.

#### Outcomes under the auction

Total costs to *members* under the auction are likely to be low. The auction involves a fundamental shift in responsibility from individuals to government that means only those members who actively opt out of defaults face search costs.

Total costs to *employers* under the auction are likely to be very low. Employers will be relatively detached from the process with no obligations other than to direct contributions to allocated funds.

Total costs could be high for some *funds*. While participation costs would be low, there would be material marketing expenses. Funds that did not participate or are unsuccessful will face high marketing costs in trying to capture choice members. Ultimately, these costs will impact on members and/or shareholders.

Total costs to *government* should be low. Establishing the panel and running the auction could cost somewhere in the order of \$2.5 million per process. Monitoring would also add to regulatory costs given that funds are required to commit to minimum levels of member services in the pre-qualification stage (although the number of funds to be monitored is low). Establishing a system for sequentially allocating members to default products would also constitute an additional cost (in the event there are multiple winners). This system could be an extended function of the centralised online service (chapter 3).

However, if appropriate products are selected and more people are in products that maximise long-term net returns, the auction may reduce reliance on the Aged Pension, and with it the deadweight losses from raising tax revenue to fund it.

### Assessment of the auction relative to the baseline

Overall, system-wide costs are likely to be slightly lower under the auction than the baseline. Under the baseline, search costs may be small for many members if they outsource the decision or make a relatively passive one. However, the decision and action required of all new entrant members under the baseline, as well as higher rates of switching among existing members, suggests that in aggregate these costs would likely outweigh the higher costs for government and funds under the auction.

### 6.4 Overall assessment

Table 6.2 summarises the costs and benefits of the auction model.

The main risks of the model are unsustainable bidding strategies and that the primary focus on fees comes at the expense of other aspects of performance, including innovation or higher cost investment strategies focused on long-term net returns. Other risks include bids well exceeding costs and winners raising other fees not committed to under the auction.

Some of the features of the prototype auction model proposed are intended to address these risks. Implementing such design features however presents its own challenges.

- Accounting for past performance in the pre-qualification stages of future auctions is intended to increase incentives for winners to keep their commitments. Yet to be effective this must present a credible threat to the winning bidder.
- Including investment fees is intended to reduce the risk that funds raise fees not committed to under the auction. However, this may come at the expense of exposure to potentially higher-yielding, but costlier, asset classes that can benefit diversification and long-term net returns.

The Commission welcomes participants' views on the effectiveness and workability of these and other aspects of the auction model assessed.

Table 6.2	Auction model: summary	
Criterion	Assessment	
Member benefits	To the extent that investment returns are largely market driven, focusing the nature of competition on fees would promote long-term net returns, despite the potential for it to push funds away from particular higher cost asset classes.  The pre-qualification stage (if well designed), would reduce the risk of low fees coming at the expense of member services.	
Competition	Funds mainly compete on member fees.  The inclusion of both administration and investment fees opens up competition to a broader set of funds than if bidding were only on the basis of administration or investment fees.	
	To the extent there is some market consolidation, this is unlikely to substantially affect competition. Fewer competitors could even provide benefits, including improved productive efficiency and greater competitive pressure on upstream providers.	
Integrity	The risk of the outcome being manipulated by funds or the panel is low, as the bidding metric is objective and collusion is unlikely.	
	Funds are held accountable by many mechanisms, including mechanisms specific to the auction like a contractual obligation and potential exclusion from future processes, as well as existing regulations and reputation risk.	
Stability	Unlikely to create instability, because the model would not lead to excessive market concentration or volatile movement of members and assets.	
System-wide costs	High costs for government and funds are likely to be offset by the lower costs for members and employers.	

#### **DRAFT FINDING 6.1**

Relative to the baseline, a fee-based auction model would:

- promote member benefits by exerting downward pressure on fees
- focus competition on, and elevate transparency of, member fees
- likely assist integrity due to its simplicity and accountability mechanisms
- be unlikely to compromise long-term stability because the model as designed would not lead to excessive concentration of funds or volatile movement of members and assets
- have slightly lower system-wide costs, mainly due to lower search costs for members.

#### INFORMATION REQUEST 6.1

Is the format of a first-price sealed-bid with a best-and-final-offer stage and potentially multiple winners the best fit for a fee-based auction? Are there any risks associated with these design elements that have not been identified?

Regarding transparency, what would fall under the exemption of information that, if it were disclosed, could reasonably be expected to have commercially adverse consequences for the bidder?

Could a fee-based auction be designed to facilitate second-order competition between funds on non-fee aspects of performance, such as member services?

# 7 Multi-criteria tender

### **Key points**

- A multi-criteria tender would require funds to compete for default fund status by making proposals against multiple assessment criteria.
- If well-designed, a multi-criteria tender can help engender a product that performs well against characteristics that matter to members. Using a multi-criteria tender for this purpose is not without precedent: New Zealand uses this approach to select its default providers.
- There are some risks, however.
  - The criteria and their weighting may not reflect the breadth of all default members' needs.
  - The complexity of weighing multiple criteria may create a perception (or reality) that the assessment panel failed to objectively and consistently evaluate tenders.
- Tender design is critical to achieving the tender's objectives, and for helping address the above risks. The Commission designed a prototype tender for assessment against its five model assessment criteria.
- The multi-criteria tender assessed matches or betters the performance of the baseline on most model assessment criteria. Relative to the baseline:
  - member benefits would be better served by the inclusion and relatively high weighting of long-term net returns in the assessment criteria
  - competition would be focused on aspects of performance that matter to members, and would be further enhanced by the winning bid providing a market-wide performance benchmark
  - integrity may be promoted due to the multi-criteria tender's strong accountability mechanisms, but on the other hand there would be risks to integrity due to the tender's vulnerability to subjective judgments
  - stability would not be materially threatened over the longer term since the tender is unlikely to lead to excessive concentration of funds or volatile movement of members and assets
  - system-wide costs are expected to be slightly lower, with higher costs for government and funds likely to be outweighed by lower costs for members and employers.

A broad range of products and services, from defence equipment to public housing management, is procured using multi-criteria tenders. New Zealand uses a multi-criteria tender to select its default superannuation providers, and the Commission's terms of reference require it to consider the strengths and weaknesses of this model. One of the main benefits of multi-criteria tenders is that they allow the procuring agency to target the

most valuable aspects of the product or service. A tender could therefore help to address the risk of lower investment diversification under a fee-based auction (chapter 6).

Few participants commented directly on multi-criteria tenders. Of those that did, the Centre for Market Design (sub. 18, p. 7), Institute of Public Affairs (sub. 17, p. 8) and Kinetic Superannuation (sub. 45, pp. 2, 7) provided some support for the model. Kinetic Superannuation argued:

Kinetic Superannuation favours a market-based model of a competitive tender process ... A market-based tender is the most effective solution because of its ability to revitalise benchmarking against the winning product and its international acceptance as promoting competition. Because of its adaptability throughout commercial relationships and public sector procurement a tender can accommodate itself to the regulatory regime with minimal disruption and without causing undue cost and complexity. (sub. 45, pp. 2, 7)

A number of other participants were opposed to using a multi-criteria tender, in part due to the difficulty involved in assessing subjective criteria.

While a system-wide auction or tender model has the potential to bring more market forces to bear on default allocation, ASFA considers that the risks and potential costs of this model far outweigh these potential benefits. Some of the most significant potential negative outcomes ... [include] ... difficulties in establishing objective and quantifiable criteria to evaluate the bids for factors like levels of service. (ASFA sub. 24, p. 3)

Under a market based model, there would need to be several criteria, including qualitative components. This raises the question as to how to assess the tender responses of different Funds, and how to trade off against competing results on different measures. Creating an appropriately rigorous and transparent framework would be difficult and potentially complex. This may be particularly difficult in the case of qualitative factors. (IFAA et al., sub. 13, pp. 7—8)

Expanding an auction or tender to consider other criteria introduces additional complexity and inefficiency. In particular, the government has to select a set of parameters upon which to optimise. There is no set of criteria that could in the real world be dynamically efficient without perfect information. (FSC sub. 38, p. 15)

Some of the concerns about the complexity of tenders are legitimate, but they are not insurmountable. Tenders are well-established mechanisms for injecting competition into allocation models. As such, the Commission has explored whether a multi-criteria tender could be designed that adequately meets the five assessment criteria presented in chapter 2. The chapter first considers the key design elements of a tender (section 7.1), then proposes a tender model for assessment (section 7.2) (table 7.1), and finally assesses the model against the assessment criteria (sections 7.3 and 7.4).

Table 7.1 Su	mmary of key features of tender model				
Main design element	Design features				
Pre-qualification	Products must pass a pre-qualification process with respect to services and fees.  Funds must prove they can manage expected inflows of default funds.				
Assessment criteria	Past performance on net returns and independent surveys of member satisfaction. Investment strategy and governance. The quality of member services, engagement and advice. Fee levels and transparency. Innovation in other areas.				
Number of winners	Five to ten.				
Allocation of members	Sequential allocation.				
Transparency	Information to be disclosed unless its publication can reasonably be expected to have commercially adverse consequences for the bidder.				
Monitoring and enforcement	Terms of appointment specified in a contract.  Account for the winners' performance in considering eligibility for future tenders.				

## 7.1 Elements of tender design

Participants in a multi-criteria tender compete by making proposals against a number of different assessment criteria. Criteria are typically weighted by their relative importance.

While some tender criteria may be relatively easy to measure (such as fees), some require judgment about the quality of each participant's proposal. For example, a tender for the right to provide a service may require participants to explain the quality of proposed member services. In this case, the quality of each participant's proposed member services would be assigned a score. The weighted scores for each criterion are then added together to produce an overall score for each participant.<sup>24</sup> The overall scores provide a basis for ranking bids and identifying the winners of the tender.

Multi-criteria tenders offer a number of potential benefits. A well-designed tender can help engender a product that performs well on characteristics that meet members' needs. Non-prescriptive criteria give funds an incentive to innovate, and the flexibility to offer products that specialise on certain characteristics. To the extent that the criteria and their weightings reflect the needs of members, the tender process can thus drive funds to discover the unique combination of product characteristics that best meet members' needs.

<sup>24</sup> Scores may first be normalised, usually by indexing against the 'best' score for that criteria. In the case of a fee-based criterion, the best score would be the lowest fee.

### There are fundamental challenges in designing a tender

Selecting default superannuation products using a multi-criteria tender would entail several risks. Some of these risks are not unique to tenders, arising in other allocation processes.

### Inconsistent assessments and failing to keep the winners to their commitments

There is a risk that assessments of tender proposals will be inaccurate or inconsistent. This risk arises from the subjective nature of some tender criteria, such as the quality of the investment approach or member services. While the quality of member services can be measured, as illustrated by ratings services such as SuperRatings and Chant West, doing so nonetheless requires some judgment, which can be disputed.

The subjective nature of the criteria also increase the risk of not being able to keep funds to their commitments. Again, this risk arises from the subjective nature of some criteria: while assessing whether winners have kept their commitments on an objective measure such as fees is relatively straightforward, determining whether they have met their commitments on their investment approach or member services is more difficult.

### The criteria and their weighting may fail to reflect members' needs

The organisation procuring a service through a tender often does so on behalf of a separate end user. For example, a government procuring infrastructure construction services is doing so on behalf of the broader public, which will pay for and use that infrastructure. As such, a fundamental challenge is ensuring that the criteria and their weightings reflect end user needs. In this context, the criteria specified in the tender process can be seen as an attempt to substitute for the signals that would arise in an open and competitive market. Developing criteria that reflect default members' needs is difficult in a tender for default superannuation products, given that most default members are disengaged from superannuation and thus do not send market signals.

Compounding this difficulty is that members' needs can change over time. However, to the extent that changes in members' needs can be identified, criteria can be updated and reweighted as tenders are repeated, as occurred in New Zealand (Mercer, sub. 15, p. 9). As noted in chapter 3, periods between tenders should be shorter in the early stages of a new model

### The process may be non-competitive due to bidder collusion

The potential for collusion arises as the seller has better information than the procurer. As discussed in chapter 6, the key risk factors for collusion are having multiple rounds, repetition over time, a low number of bidders, and multiple winners. Multiple rounds provides scope for signalling, and repetition over time allows more sophisticated signalling across tenders. Tenders with relatively few bidders make organising and maintaining a

collusive agreement easier. And in multiple-winner tenders, an agreement is easier to form as units can be more easily shared among bidders.

While some of these risk factors would apply to a multi-criteria tender (repetition over time and multiple winners) the Commission considers the overall risk of collusion is low. Collusion would be made more difficult by three factors. First, participation is likely to be relatively high. For a large group of funds, the pool of new default members would provide a material source of contributions that would assist those funds in securing long-term sustainability (chapter 3). Second, the tender can be designed to limit signalling before and during the process; for example, by using sealed bids and prohibiting any communication before the process. Prohibiting pre-tender communication would be easier to enforce than in traditional procurement processes given bidding parties will be stand-alone funds rather than consortia. Further, signalling over time is made more difficult for funds given criteria are subject to change between processes. And third, given the market is not captive (members can exercise choice at any time) the incentives to collude are weakened.

#### Designing a tender: what are the levers for mitigating risk?

Tender design is critical to achieving the tender's objectives, and for helping to address the above risks. Policy makers have a number of choices when it comes to tender design. These choices cut across the three main stages of a tender — pre-tender, conduct during the tender, and post-tender — and include the:

- pre-qualification stage
- bidding criteria
- governance arrangements for the tender process
- number of 'winners' identified
- frequency with which tenders are held
- monitoring and enforcement mechanisms and rules that apply after the tender.

Notably, these levers would not operate in a vacuum: much of the existing policy and regulatory framework for products and funds — which also work to further mitigate these risks — would apply.

#### Pre-qualification stage

Most multi-criteria tenders require participants to meet certain conditions in a pre-qualification stage. Bidders typically provide basic information about themselves and their services through an expression of interest to compete in the tender. In New Zealand's 2014 tender process, participants had to, among other things, undergo stress testing of their systems and processes to ensure they could deal with expected member volumes and be operational when allocation began (appendix B).

Pre-qualification can serve a number of purposes. By excluding firms that clearly fail to meet minimum required standards, pre-qualification can reduce the total number of tenders to assess. This is important given that assessing a tender is time-intensive and thus costly.

A pre-qualification stage has its own risks, and so must be designed carefully. The criteria should not unnecessarily exclude participants and in so doing reduce competition and the diversity of bids. Another challenge is ensuring the criteria provide incentives for participants to innovate to reduce costs and better meet members' needs, rather than just meet minimum requirements.

A number of inquiry participants supported using MySuper (or a strengthened version of it) as a pre-requisite for default products (AIST, sub. 28, p. 33; CIFR, sub. 7, p. 7; IFAA et al., sub. 13, p. 8; Kinetic Superannuation, sub. 45, p. 4; Mercer, sub. 15, p. 3; PwC, sub. 12, p. 3; WSSA, sub. 11, p. 2). Other proposals included limiting the set of default providers to funds that successfully retrieve unpaid Superannuation Guarantee contributions (AustralianSuper, sub. 19, p. 3), providing unbiased advice and transparent performance indicators (Centre for Market Design, sub. 18, p. 5), and satisfying regulatory audits (Kinetic Superannuation, sub. 45, p. 4). AIST (sub. 28, p. 44) argued that products should be ineligible if they consistently fall below a minimum net return standard, such as the lowest 10 per cent of performers.

#### Criteria used in the comparative evaluation stage

An important design element of a tender is the criteria that participants bid on. The criteria should reflect members' needs and in doing so promote their best interests.

Inquiry participants identified a number of features and performance metrics of funds and products, many of which could be used as criteria in a tender. The criteria identified fall into two main groups.

- Fund and product features, including the investment strategy across asset classes (accounting for risk), quality of member services, insurance offering, governance quality, fee levels and the ability to tailor to members' needs (AIST, sub. 28, pp. 43— 44; CIFR, sub. 7, p. 7; First State Super, sub. 26, p. 2; IFAA et al., sub. 13, p. 7; Mercer, sub. 15, p. 5; REST, sub. 23, p. 7).
- Past performance measures, namely historical net returns and the results from member satisfaction surveys (AIST, sub. 28, p. 43; FPA, sub. 29, p. 8; Kinetic Superannuation, sub. 45, p. 4; Mercer, sub. 15, p. 5; REST, sub. 23, p. 7).

These criteria broadly reflect current industry practice for comparing superannuation funds. Industry consultants, for example, also account for current fund features and past performance measures when assessing and rating funds (Chant West 2017; SuperRatings 2017). And corporate tenders are typically based on similar criteria (ISA, sub. 38 and Mercer, sub. 31 to PC 2016). The Northern Territory Government (2014) noted that its default fund for government employees has a proven strong investment performance and low capped administration fees. The Commission's stage 1 study, which drew on considerable input from industry stakeholders, identified various system-level indicators that align with the fund- and product-level criteria above.

The two main groups of criteria — fund and product features, and past performance measures — each serve a slightly different purpose. Fund and product features help to identify products that are most suitable for default members. Past performance measures on the other hand create ongoing incentives for good performance, since performance will be accounted for in the next tender (a 'repeat game'). As such, past performance measures — regardless of the extent to which they are indicative of future performance — help to reduce the risk that funds will provide sub-optimal effort or renege on their commitments after winning a tender.

Each criterion must be assigned a weighting that reflects its relative importance. In the New Zealand tender, criteria related to organisational capability, member education and investment capability (including a proven track record in funds management performance) received a 70 per cent weighting, with pricing levels accounting for the remaining 30 per cent. The Tasmanian Government's (2014) general procurement guidelines suggest that non-price criteria be weighted between 10 to 40 per cent, and price criteria between 60 to 90 per cent.

A key challenge in developing criteria and their weights is ensuring they reflect the needs of default members. Notably, these needs may differ from the needs of choice members. For example, while many active members may place a high value on a mobile application that tracks investments in real time, default members may not. As such, the criteria would need to be developed carefully.

#### Selection body and transparency

As discussed in chapter 3, the selection body should have an obligation to act in members' best interests and an understanding of their needs. Practically, this means they should be independent and free of any interests and involvement in the participating funds. It also suggests they should have no ongoing regulatory role, lest there be an incentive to favour a fund that offers some form of advantage to the regulator.

Given the degree of judgment that may be needed in assessing and ranking bids, some expertise would be required. However, good incentives are likely far more important — panel members need not all be technical experts in finance and investment. The ability to comprehend relevant information (itself requiring a high level of financial literacy) should be sufficient. Collectively, the panel should offer a wide range of skills and expertise. The potential for subjectivity in assessment also reinforces the case for independence and accountability in the form of transparency and review processes. A panel that makes or is

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Past performance indicators also have a role to play in identifying suitable products. However, the role of net returns may be limited, since past returns are not necessarily indicative of future returns.

in the process of making a poor choice risks creating a loss of confidence in the system. While design can mitigate some of this risk, the ultimate sanction is to cancel the process and replace the panel. This power must be available to the government.

Broadly, the more transparent the process the better. A high degree of transparency will promote integrity (and ultimately trust) in the process. However, there may be information that could reasonably be expected to have commercially adverse consequences for the bidder. As discussed in chapter 6, it is important to balance the confidentiality needs of funds against the need for transparency. The Commonwealth Procurement Rules state:

The need to maintain the confidentiality of information should always be balanced against the public accountability and transparency requirements of the Australian Government. (Department of Finance 2014, p. 21)

The Commission is seeking further feedback on the optimal level of transparency.

#### Number of winners

A tender could identify a single winner or multiple winners. A number of participants argued there are (in general) risks from having a single or limited number of winners, including reduced system stability and increased market concentration (ASFA, sub. 24, pp. 13-14; FSC, sub. 38, p. 27; IFAA et al., sub. 13, p. 4), albeit these comments were framed in the context of the Commission's issues paper, which countenanced an allocation system that applies to all default members, rather than just new entrant default members.

Some participants contended that a single winner (or a small number of winners) could come at the expense of product variety. The Association of Superannuation Funds of Australia argued:

A limited number of generic default super funds would exclude funds from specifically creating niche products to meet particular default fund markets. There may be some industries which have specific characteristics that can be met by the existing default fund as that fund was created to service that particular type of employee or demographic. Such specific characteristics could not be provided in a generic default product designed for people from many different and heterogeneous industries. (sub. 24, p. 13)

If the tender has multiple winners, there would need to be a rule for determining how winners are selected. Two potential approaches are:

- selecting a number of the best overall performers. The New Zealand tender process uses this approach, selecting nine winners in its 2014 tender
- selecting the best performers on particular criteria categories. For example, the funds that perform best on performance history, member services and investment strategy respectively.

Selecting multiple winners would also require consideration of how employees are allocated to default products. In the New Zealand tender employees are allocated to default products sequentially.<sup>26</sup> Having multiple winners and sequential allocation would mean that default members are allocated to products that, though all may be high quality, will each provide a slightly different bundle of services. This is an inevitable outcome of such a model. Alternatively, employees could be allocated by employer (chapter 8) or employee (chapter 5) choice. In these cases, it would also be important to consider how information on the winning products is presented.

#### Frequency

As discussed in chapter 3, there are risks associated with the process being too frequent or too infrequent. Holding the process too frequently risks encouraging short-termism and would exacerbate the costs to participating funds and government (Mercer, sub. 15, p. 6; ACTU, sub. 34, p. 10). And although the risk is low in any case, high frequency could also increase the risk of collusive agreements being maintained (see above). On the other hand, there may be an industry concentration concern if the process is held too infrequently (CSA, sub. 35, p. 9). The auction process also reveals useful information, which is another argument against less frequency.

#### Monitoring and enforcement mechanisms

There is a risk that the winners of a tender fail to meet their commitments made against the tender criteria. For example, trustees could fail to meet promised standards of service quality or investment management. The relationship between the winners of a tender and its default members — and therefore the risk that funds fail to meet their commitments — can extend well beyond the relevant default period.

There is a range of measures already in place that would help to regulate the conduct of the winners of a tender. These measures include trustees' fiduciary duties, statutory obligations (including those in the *Superannuation Industry (Supervision) Act 1993* (Cwlth) (SIS Act)), and various provisions in competition and corporations law such as the dishonest conduct, inducing persons to deal, and misleading or deceptive conduct provisions. However, while these measures play an important role, they would be insufficient to ensure winning funds meet all of their specific commitments.

Further options for addressing the risk that funds fail to meet their commitments include the following.

 Accounting for past performance in subsequent tenders, such as by accounting for historical long-term net returns and the results of member satisfaction surveys, would motivate previous winners to meet their commitments. The pre-qualification stage in a

Under a model of sequential allocation, each default fund takes a turn in being allocated a new entrant default member, with the process (including the order of allocation across funds) indefinitely repeated. This model results in an even allocation of default members across winning funds.

subsequent tender could further assist by precluding a previous winner from competing if it reneged on its past commitments.

- Regulatory mechanisms, such as a licensing regime for default fund providers with ongoing monitoring and reporting requirements, with the threat of removal of default status and potentially loss of default members if there is non-compliance. Alternatively, the commitments made by the winning bidders could be confirmed in a voluntary code of conduct or memorandum of understanding.
- Contracts that specify fees and service levels, with ongoing self-reporting obligations. Winners of the New Zealand default tender must sign a contract with the government (referred to as a 'terms of appointment'). Corporate tenders are also usually confirmed in a contract.

Unlike the supply of many other products and services, the provision of a superannuation product is a long-term proposition and subject to various market forces outside the control of superannuation funds and trustees. As such, it would be misleading (and difficult) to assess the performance of the supplier over short periods. These factors need to be taken into account in the design of mechanisms to ensure performance following a tender.

#### 7.2 The tender model considered for assessment

The Commission has designed a prototype multi-criteria tender for assessment. The tender would provide the winners with access to the flow of new entrant default members over the designated default period (and beyond if default members stay with the winning fund) (chapter 3). As outlined in chapter 3, any competitive allocation mechanism, including a tender, should initially be held every four years.

The tender would be administered by an independent panel, constituted by the Australian Government. The panel would advise the relevant Minister on which fund or funds should be selected for default status, with this advice made public. The Minister would be free to accept or reject the advice, although the reasons for any departure from the panel's recommendations would have to be made public to ensure transparency.

The model for assessment consists of three main stages.

- 1. Pre-qualification stage a tender evaluation plan is released and participants lodge an expression of interest to compete in the tender. This stage limits participation in the tender to those products and funds that meet certain criteria.
- 2. Comparative evaluation stage participants submit a detailed proposal that specifies pricing, services and other characteristics of their default product. Service proposals are evaluated and assigned an index score. The panel would have the right to conclude this stage by asking some participants to submit a 'best-and-final-offer', which would help to encourage convergence where offers are close. The winning offer would be

formalised in a contract, and default employees would be sequentially allocated across winning funds.

3. *Performance monitoring stage* — the winning providers would self-report against the commitments in their contracts. Winning providers that materially breach their commitments during the default period would lose default status.

### Pre-qualification stage

The pre-qualification stage is intended to filter out funds that are clearly unsuitable to winning default status. To pass the pre-qualification stage products and funds must each meet minimum conditions.

- Funds must prove they can safely handle expected inflows of default fund members. As such, the assessment panel would assess funds on factors such as stability, liquidity, regulatory compliance and governance arrangements.
- Product features would be limited, corresponding to the criteria assessed in the
  comparative evaluation stage. Any fees excluded from the comparative evaluation stage
  would be limited to cost recovery. Requirements relating to the investment approach
  would not be specified (as occurs under the pre-qualification stage for the auction),
  since this is considered in the comparative evaluation stage (see below).
  - The assessment panel would have the option to use pre-determined thresholds (for example, a minimum level of improvement in fees or a minimum reduction in investment delay before funds are placed) to help sieve bids. To inform funds of future expectations, these could be published.

The pre-qualification process for funds and products would be similar to a strengthened MySuper authorisation process (discussed further in chapters 5 and 8). The Australian Prudential Regulation Authority (sub. 33, p. 2) has argued there would be merit in lifting the bar for MySuper by introducing 'stronger authorisation requirements and a broader member outcomes assessment'.

### Comparative evaluation stage

#### Bidding criteria and transparency

The current legislated criteria in the *Fair Work Act 2009* (Cwlth) (for determining whether a product can be included as a default in modern awards) are too vague to be used in a multi-criteria tender. Specific criteria would need to be developed for this purpose.

The default product should focus on the accumulation stage and consist of a bundle of services that is the minimum necessary to meet the Government's stated objective of the superannuation system (chapter 3).

For the purposes of assessing a multi-criteria tender, and reflecting submissions from inquiry participants, it is proposed that the comparative evaluation stage would require participants to submit tenders against the following criteria.

- Past performance on net returns and independent surveys of member satisfaction. The net returns measure — which should have a relatively high weighting — would be the average of annual past net returns across the fund's products over the past five years (which may all be non-default products). To facilitate market entry, the assessment of past returns would not be confined to superannuation products: performance history could come from a similar investment product. Bidders without a performance history in the Australian superannuation system would be assessed based on their performance in offshore markets. The scores for each bidder would be indexed against one another (that is, the best performing product would receive a score of, for example, 100, with other products' relative performance determining their score relative to this benchmark).
- Investment strategy. This would include an assessment of the planned asset allocation, investment governance, quality of the investment team and management, and the processes for selecting external fund managers. The assessment would centre on whether the investment approach is consistent with investment performance targets and maximising long-term net returns (including through effective diversification). These latter measures do not require a performance record, and as such put potential entrants on an equal footing with incumbents, helping to reduce entry barriers.
- The quality of member services, engagement and advice. This would include an assessment of the proposed administration services for members, and tools that help members to understand and plan for their retirement, and to resolve any issues or questions that may arise. Participants would not be rewarded for proposing services considered superfluous to default members' needs (chapter 3).
- Fee levels and transparency. Participants would tender the administration and investment fees they intend to charge. Participants would also explain how they intend to make all of their fees transparent to members.
- Innovation in other areas. This criterion allows for the likelihood that there is scope for superannuation providers to innovate and improve their services and products in areas not explicitly included in the above criteria.

The quantifiable criteria — past net returns, results from member satisfaction surveys, and fee levels — would be indexed against the best performing tender on each measure. For the other criteria, the assessment panel (chapter 3) would issue each participant a score out of ten, with this score indexed against the highest score across all participants for that criteria. The tender evaluation plan would outline what is required to receive a score of 10, 9, 8 and so on

There is also the question of whether bids should be released to the public. As explained in section 7.1, there are benefits for public trust and bidding competiveness from more transparency, but this needs to be balanced against commercial sensitivity for funds. Information should only be withheld if it can reasonably be expected to have commercially

adverse consequences for the bidder. An example of information that may be reasonably withheld would be a novel product feature included in a bid. Such information has the potential to create value for members, and mandating its disclosure could blunt the incentive to produce it in the first place. However, at the very least, high-level information such as the number of participants, and the number that met pre-qualification and minimum improvement expectations should be published to give funds a feel for the competitive landscape.

#### Number of winners

The panel would identify up to 10 of the overall best performers as the recommended winners of the tender. An indicative range may be between 5 to 10 winners. The number of recommended winning funds should be decided by the assessment panel on a case-by-case basis. The panel should account for the following factors when deciding how many winners to recommend.

- The number of participants. The number of winners should be fewer than the number of participants. Otherwise, the tender process would be non-competitive. For example, if the panel announces there will be ten products recommended for default status, but market knowledge suggests only ten or so have a reasonable chance of winning, funds could submit relatively non-competitive offerings and still expect to be selected.
- *The distribution of scores*. The number of winners should not arbitrarily exclude a relatively well-performing bidder. For example, if it is announced there will be seven winners, but there are eight stand-out bidders with very little separating the seventh and eight best scores, the number of winners should be revised to eight.

#### Allocation of default members and the best-and-final-offer

Employees are allocated to products sequentially.<sup>27</sup> This would occur by the government sequentially allocating new default members across products. This approach, used in New Zealand, would impose a lower burden on employers and employees than if they were required to choose.

Sequential allocation would generally result in members being allocated to products with slightly different bundles of services. Allowing service bundles to differ would help to facilitate a competitive process whereby funds discover the set of product features that best meet members' needs. At the same time, there is a small risk that a fund could get on the winners list despite an aspect of its service offering being clearly inferior to other winners.

A best-and-final-offer stage would provide the assessment panel with the opportunity to reduce the extent of this disparity, and enable funds to rectify an element of its service in

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<sup>&</sup>lt;sup>27</sup> Chapter 5 considers a scenario where employees instead choose their product. Chapter 8 considers a scenario where employers choose (with an administrative filter).

what is an otherwise competitive offer. The best-and-final-offer stage would only be open to a limited number of participants, as judged by the assessment panel on the basis of the overall number of participants, and the distribution of tender scores.

#### Performance monitoring stage

The following mechanisms would increase incentives for winning bidders to meet their commitments.

- Contract with ongoing communication and disclosure. Commitments made by winning bidders would be confirmed in a contract with the responsible Minister. The contract would apply in the default period and provide a reference point for assessing whether past winners have kept their commitments. Winners would need to transparently self-report against their commitments on an ongoing basis. Ultimately, the relevant Minister would be responsible for enforcing the contractual obligations of successful funds.
  - The contract would outline processes for managing the exit of underperforming funds within the 4-year default period. In the event that a fund has its default status revoked, its default members would be notified, and unless they opted to remain with the fund, would be sequentially allocated across the remaining default providers.
- Accounting for past performance in future tenders. Past performance would be accounted for in two ways.
  - As part of the pre-qualification stage, any past tender winners would be excluded from progressing further if they fell materially short of previous commitments. A breach of previous commitments would arise, for example, if a fund did not provide the level of member services promised in a past comparative evaluation stage.
  - The criteria would explicitly account for past long-term net returns and the results of member satisfaction surveys. If these are given sufficient weighting in the assessment of tenders, they would motivate funds to continue to act in members' best interests, in order to win future tenders.

The risk of a fund reducing the quality of its default product following a merger with a non-participant would be addressed by the contract and current regulatory measures. Default members who stood to lose from a merger would be protected by the SIS Act<sup>28</sup>. As discussed in chapter 3, a formal framework that requires fund trustees to give genuine consideration to merger proposals in the context of member interests would also need to be considered.

<sup>&</sup>lt;sup>28</sup> The SIS Act imposes a general obligation on trustees to act in members' best interests, as well as a specific 'equivalent rights' test for successor fund transfers (chapter 3).

In the event that a default provider fails to win a future tender, it would be free of any contractual obligations. The provider would then have more flexibility to change its fees and conditions, which may not best meet the needs of existing default members. As noted by Mercer (sub. 15, p. 10), this scenario must be carefully considered in any tender system.

Existing regulatory measures would provide some protection for default members. Funds should not, however, be forced to notify members themselves if they fail to win default status in a future tender, lest members be given an indication that performance is poor when it is in fact just outside the top 4 or 5. It is quite plausible that a default product may not win a subsequent tender but still be a good option. It is in practice the difference between being in the top 4 or 5 at a point in time or being in the top 10. Instead, the Government can help to keep the system participants informed by transparently publishing and announcing the results of future tenders.<sup>29</sup>

## 7.3 Assessment of the model

The Commission has assessed the prototype tender against its five assessment criteria: member benefits, competition, integrity, stability and system-wide costs (chapter 2). In doing so, it has drawn on a range of evidence sources, including submissions from inquiry participants, conceptual analysis, the literature on mechanism design, and outcomes from other sectors and countries.

#### **Member benefits**

Member benefits are met where funds have incentives to maximise long-term net returns and allocate members to products that meet their needs (chapter 2).

#### Outcomes under the tender

The selection criteria in the multi-criteria tender help to directly promote member benefits. The criteria include the results of member satisfaction surveys and long-term net returns, with the latter complemented by an assessment of the current investment approach and investment return targets. The results of member satisfaction surveys and long-term net returns would be weighted higher than the other criteria. As such, a fund that performs relatively poorly on these measures would be at a significant disadvantage in the tender.

The benefits extended to members would be magnified with multiple winners, since more incumbent default members would receive the conditions secured in the auction (although scale economies and incentives to compete would be lower with more winners).

However, as noted above, in the event that a product has its default status revoked within the four year default period for failure to meet contracted standards, its default members should be notified.

Because the tender process would initially be repeated every four years, the inclusion of past performance measures in the selection criteria provides ongoing incentives for good performance. These incentives would apply to any fund that wants to win a future tender, regardless of whether they were successful or unsuccessful in a past tender. Benchmarking participants' long-term net returns against each other would also mean that the more a participant out-performs its competitors, the higher its score in a tender, reducing the likelihood that funds cluster around middling levels of performance, to the long-term detriment of their members

The benefits from selection criteria that target member benefits are likely to extend into the choice segment of the superannuation product market. This is because winning bids, which would be made public, would provide a market-wide performance benchmark for members that choose their superannuation provider. Kinetic Superannuation argued:

... market models are generally more efficient than administrative allocation models and have the advantage of revealing the relative performance of products. Not only does a tender promote visible competitive bidding but its regularity of recurrence can facilitate cost reduction and innovation as funds benchmark themselves against successful bidders. (sub. 45, p. 2)

The Centre for Market Design similarly argued that well-managed default funds are valuable insofar as they:

... create clear reference points, against which comparison may be made using credible independent metrics. (sub. 18, p. 4)

Further effects on competition are considered in the assessment of competition below.

#### Assessment of the tender relative to the baseline

The tender is expected to better promote member benefits than the baseline. While employees are more likely to be engaged under the baseline, they might be constrained by information problems and the complexity involved in choosing a fund. This may in turn reduce incentives for funds to maximise long-term net returns (chapter 4). In contrast, under the multi-criteria tender the focus on long-term net returns would increase incentives for funds to compete on this measure, including through the winning bids providing a market wide performance benchmark.

#### Competition

The tender should foster competition that drives innovation, cost reductions and more efficient long-term outcomes for members (chapter 2).

#### Outcomes under the tender

Competition in the tender is expected to be sufficiently strong to engender good outcomes. While not all funds will choose to participate — indeed the very largest may have good reasons not to — the bulk of mid-sized funds currently dependent on default inflows or with deteriorating net outflow ratios will find strong reason to do so.

Notably, a well-designed tender does not necessarily require a large number of competitors to generate sufficient competitive tension. Rather, in many circumstances it should be sufficient for the number of competitors that are capable of winning the tender to exceed the number of winners. It would be important however to consider the impact of the number of winners on incentives to compete — too many would dilute the pool of new entrant default members, reducing the intensity of competition. And the competitive tension from having nine winners out of ten participants is likely to be much lower than where there are four winners out of five participants. While ongoing participation would depend on the integrity of the process and the costs of bidding, these issues can be addressed through careful design of the tender.

In terms of the *nature* of competition, to the extent that the criteria and their weightings reflect members' needs, the tender goes some way to achieving the competitive tension that would exist in a market with active and informed users. Moreover, multiple criteria provide funds with flexibility to discover the best combination of fees, investment approach and member services. The use of non-prescriptive criteria with no pre-defined solutions can provide incentives for innovation. Where a beneficial development in member services is observable in other markets, a minimum improvement criterion could also encourage change. And the criteria should be varied over iterations of the tender, in conjunction with expert advice.

At the same time, the inclusion of past performance measures — and in particular requiring a performance record of at least five years — would create a barrier to entry. The height of this barrier would be limited however by allowing funds that have not provided default superannuation products in Australia to use their performance record in similar investment products locally or offshore. More generally, entry could still occur in the choice segment of the market. Once funds have survived for five years in an investment market (which in itself provides a sort of 'competency filter'), they could seek to win access to default members though the tender. More generally, by excluding new suppliers with no performance history anywhere, the inclusion of past performance measures improves the integrity of the process (see below).

As highlighted in the above section on member benefits, the tender process would also affect competition in the broader market for superannuation products. Winning bids would attract attention from other funds and choice members and their advisers, providing a market-wide performance benchmark. Other funds may seek to improve their products to prevent their members from switching to the winning fund. Moreover, those funds that miss out on default status should have greater incentives to improve their products in order

to attract new members through active choice. While Chile's experience with a fee-based auction suggests that these incentives might be limited in their effect, the likelihood of consolidation in Australia (see below) is a more obvious driver of product improvement amongst unsuccessful bidders than it may be in concentrated overseas markets.

The tender could also affect competition in the broader market by altering market structure. Some participants were concerned that a competitive allocation process would create excessive market concentration (APRA, sub. 33, p. 3; FSC, sub. 38, p. 15). APRA said:

... significant industry consolidation may result in much higher levels of industry concentration, potentially removing the incentive for the remaining, much smaller number of, large incumbent funds to vigorously compete under the default allocation model. (sub. 33, p. 3)

A tender would likely help to facilitate some market consolidation. There are currently 115 MySuper products (APRA 2017c) and some MySuper providers may seek to merge with another fund if they lose access to default members for four years.

To the extent there is some market consolidation, this is unlikely to substantially affect competition given the very deep market in Australia. Indeed, as highlighted above some stakeholders have suggested there is room for industry consolidation (for example, APRA, sub. 33, p. 3; Chant West 2015). Fewer products and competitors could provide benefits, including improved productive efficiency through scale economies and greater competitive pressure on upstream providers of superannuation services.

#### Assessment of the tender relative to the baseline

The tender is expected to improve competition over the baseline. Under the baseline, the market would be highly contestable and there would be strong rivalry between funds. As noted in chapter 4 however, there is still scope for funds to compete on attributes that are not in members' best interests. In contrast, under the multi-criteria tender the selection criteria and likelihood of consolidation would focus the nature of competition on maximising long-term net returns and member satisfaction.

#### Integrity

The multi-criteria tender could promote a high-degree of integrity in the selection and delivery of default superannuation products, and the behaviour of superannuation funds more broadly (chapter 2). Two factors warrant particular attention in the context of a multi-criteria tender: the potential for the allocation process to be manipulated, including by a misalignment of incentives between the selector and member, or of collusion among tender participants; and the strength of accountability and transparency mechanisms in place to ensure funds are held to account for the outcomes they deliver.

#### Outcomes under the tender

Given the degree of subjectivity in bid assessment, there is a risk that the selector can be captured by the industry (or particular segments of the industry) or is too risk averse and is captured by political concerns (ISA, sub. 40, p. 32). There may be difficulties in maintaining a truly independent panel, although accountability and transparency measures help counteract this.

Collusion poses a relatively small risk to the integrity of the multi-criteria tender for three reasons. First, participation is likely to be relatively high given the existing depth of the market and the reliance on default flows for many funds. Second, funds would submit sealed bids. This would effectively eliminate scope for signalling during the process. Further to this, dynamic criteria make signalling over time more difficult, and communication between funds before the process would be explicitly disallowed and easier to enforce than in traditional procurement processes given bidding parties will be stand-alone funds rather than consortia. Third, given the market is not captive (members can exercise choice at any time) the incentives to collude are weakened.

Accountability of funds is promoted via consideration of past performance in future tenders (including potential exclusion), and a contract with government including ongoing communication and disclosure. These enforcement mechanisms are on top of expected compliance of fund trustees with their fiduciary and statutory obligations along with other existing laws and regulations (chapter 4). While breaches may be obvious in some cases, disputes may be more difficult to resolve in cases where the fund has followed the 'letter' but not the 'spirit' of the commitment. Ongoing disclosure would act as an incentive to avoid reputational damage. Nonetheless, a residual risk remains that a fund alters the terms of the product after the designated period, negatively affecting members.

Integrity is also enhanced by the requirement for funds to have at least a five year history of providing a superannuation or like product, which removes the possibility of new suppliers with no performance history gaining access to default members.

#### Assessment of the tender relative to the baseline

All considered, the Commission cannot make an unequivocal judgment on how the multi-criteria tender performs relative to the baseline on integrity grounds. While the baseline may see many members leaving important decisions to potentially conflicted individuals, there is no absolute certainty that the assessment panel will itself be completely free of conflicts and able to make difficult choices that are in the best interests of members. However, the accountability and transparency mechanisms of the tender are likely to be more effective in holding funds to account than unassisted active choice.

#### Stability

The tender process should not create a degree of instability in the superannuation system that would lead to any significant systemic risks (chapter 2). To this end, the tender should not lead to excessive concentration in the superannuation product market or upstream supplier markets, volatile movement of members and assets, or widespread adoption of unsustainable loss leading strategies that cause disruption in later periods.

#### Outcomes under the tender

The tender is unlikely to lead to excessive concentration in the superannuation product market. There are currently 115 MySuper products (APRA 2017c) and some MySuper providers may seek to merge with each other if they lose access to default members for four years. Many unsuccessful funds would in such circumstances nevertheless increase in size and should be able to also attract members through the choice segment of the market. Indeed, those funds would likely increase their efforts to attract members in the choice market.

Given the large number of funds in Australia, even a significant number of mergers is unlikely to threaten system stability. Well-informed stakeholders have suggested there is room for consolidation (for example, APRA, sub. 33, p. 3; Chant West 2015). Consolidation could even improve stability if it leads to a more efficient allocation of resources.

There will be some increase in movement of members and assets under the tender. With up to 10 winners, there is scope for the set of winners to differ from one tender to the next. However, this would not constitute volatile movement and would not put at risk the long-term stability of the system.

Nor do the incentives under a multi-criteria tender favour widespread short-term behaviour, such as loss leading practices or performance clustering. The inclusion and relatively high weighting given to long-term net returns provides incentives for funds to take a long-term approach to investment and to outperform their competitors, which provides greater scope for diversity in investment approaches. Also, some funds may choose to remain outside the tender process, sacrificing opportunity to be a default fund for benefits already captured by their current membership and success in the choice market. These funds will have a different strategy to those competing for default status, and so provide diversity in performance. With choice clearly available to all employees at any time, the likelihood of performance clustering is lowered.

#### Assessment of the tender relative to the baseline

Neither the tender nor the baseline pose a material risk to long-term stability. Both scenarios are unlikely to lead to excessive concentration or volatile movement of member

funds. Under the baseline individual decisions by employees are likely to lead to small and predictable member flows. While the tender fuels greater movement of members and assets in the short term, this can be readily absorbed by the system and thus falls well short of the levels of volatility that could compromise system stability.

#### System-wide costs

Minimising system-wide costs involves minimising the total costs across members, employers, funds, and government (chapter 2). An assessment of this criterion requires an examination of whether the tender is likely to increase or reduce the costs on each of these four parties, and a judgment on the overall cost impact.

#### Outcomes under the tender

Total costs to *members* and *employers* under the multi-criteria tender are likely to be very low. Default members incur no costs associated with making a decision given the role of allocation is assumed by government. The relative performance revealed by the tender would also reduce search costs for members who do wish to make a choice. And employers will be relatively detached from the process with no obligations other than to direct contributions to funds.

While participating in the tender would impose costs on *funds*, such as the costs of preparing proposals, overall these costs are likely to be low. The more material costs to funds will be in marketing. Funds that did not participate or are not successful will face higher marketing costs in trying to capture active choice members. Ultimately, these costs will impact on members and (in the case of for-profit funds) shareholders.

Total costs to *government* of the multi-criteria tender will be low compared to the contributions directed and the costs of poor decision-making in the future (that is, age pension costs), but nevertheless may aggregate to \$2.5 million or more over each four year cycle. The more criteria that are included the more costly it will be to run the process and monitor the winners. Establishing a system for sequentially allocating members to default products — which could be an extended function of the central information service (chapter 3) — would be an additional government cost.

At the same time, if appropriate products are selected and more people are in products that maximise long-term net returns, the tender may reduce reliance on the Aged Pension, and with it the deadweight losses from raising tax revenue to fund it.

#### Assessment of the tender relative to the baseline

Overall, system-wide costs are likely to be slightly lower under the multi-criteria tender. This is because new members search (including advice) costs are replaced by a central

process, and marketing costs to funds will be lower than under the baseline given the existence of a default option. The large number of members and thus the large aggregate search costs under the baseline means that the higher costs to government and funds are outweighed and the tender produces lower system-wide costs.

#### 7.4 Overall assessment

Table 7.2 summarises the costs and benefits of the multi-criteria tender model.

The multi-criteria tender outperforms the baseline on the Commission's assessment criteria, but with additional risks that would require mitigation. Some of the key challenges to designing an effective and workable multi-criteria tender include:

- identifying criteria and weightings that best reflect the needs of default superannuation members
- establishing effective governance arrangements including the selection and oversight of the assessment panel — that ensure tender evaluations are independent, objective and consistent, and creating rules that better ensure winning funds keep their commitments
- choosing a number of winners that creates competitive tension in the tender process without excluding relatively well-performed funds, and then allocating default members across those funds.

The Commission welcomes participants' views on whether the tender model assessed addresses these challenges, and is effective and workable.

#### **DRAFT FINDING 7.1**

Relative to the baseline, the multi-criteria tender model would:

- promote member benefits by focusing competition on member satisfaction and long-term net returns
- focus competition on aspects of performance that matter to members, and more generally through the winning bid providing a market-wide performance benchmark
- create risks for integrity due to its vulnerability to subjective judgments, yet on the other hand promote integrity through stronger accountability mechanisms
- not create any material risks to stability, since it is unlikely to lead to excessive concentration or volatile movement of members and assets
- have slightly lower system-wide costs, mainly due to lower search costs for members.

Table 7.2	Multi-criteria tender model: summary
Criterion	Assessment
Member benefits	The selection criteria, in particular the results of member satisfaction surveys and long-term net returns, help to directly promote member benefits.  These past performance measures provide ongoing incentives for good performance.  These benefits are likely to extend into the choice part of the superannuation product market through the winning bids providing a market-wide performance benchmark.
Competition	The tender would help achieve the competitive tension that would exist in a market with active and informed users.  The tender opens up the competitive process to a broad range of funds.  By issuing non-prescriptive criteria with no pre-defined solutions, the tender process provides some incentives for innovation.  Requiring a performance record of at least five years in any superannuation (or like) product would create a barrier to entry.  Any market consolidation would be unlikely to reduce competition. Consolidation could bring benefits, through scale economies and greater competitive pressure on upstream providers.
Integrity	There are risks to integrity due to vulnerability to subjective judgments. Constituting a truly independent panel may encounter difficulties.  The tender has strong accountability mechanisms in the form of contractual obligations and the threat of future exclusion, and also more broadly from fiduciary and statutory obligations on trustees and other laws and regulations.
Stability	The tender is unlikely to create instability, since it would not lead to excessive market concentration, volatile movement of members and assets or a short-term focus.
System-wide costs	The high costs to government and funds are offset by lower costs for members and employers.

#### **INFORMATION REQUEST 7.1**

Which aspects of member services should be included in the tender criteria? Do default members value the same services as choice members?

How should default members be allocated across the set of winning products? Are there problems with sequentially allocating members into products with different investment strategies, fees and services, as is implied by this model? What role could a best-and-final-offer stage play in providing a select number of funds the opportunity to improve their offer?

Regarding transparency, are there any problems with only withholding information that can reasonably be shown to be commercially sensitive? What information would fall under this exemption?

# 8 Assisted employer choice (with employee protections)

#### **Key points**

- This chapter describes and evaluates a model enabling employers to choose any default product offered by an approved provider, subject to that product meeting the minimum criteria imposed by administrative filtering.
- The diverse needs of individual employers and employees suggest a 'dual-list' approach, incorporating the use of both light and heavy filters, would provide the best outcomes.
  - A mandatory light filter would determine eligibility to be chosen as a default product (a 'mandatory minimum standards' list). A heavier filter applying stricter criteria and employing higher performance benchmark hurdles would identify a narrower 'preferred default' list of the best performing products as additional 'opt in' guidance for some employers. The preferred default list would focus on 'no frills' products with higher suitability for default members.
  - The mandatory minimum standards list would provide well-resourced employers flexibility to negotiate good deals for their workforces, while still providing a safeguard against very poor choices. The optional preferred default list would help smaller to medium sized businesses choose a high-performing product for their employees. This approach would drive improved performance, as funds would compete for their products to make the preferred list or to be chosen by large employers.
- The light filter would need to be stronger than the current MySuper authorisation criteria, and provide for the exit of underperforming products. The requirement to demonstrate adequate performance would be a more robust test than has been applied until now.
- The bodies involved in administrative filtering should be genuinely independent, free of conflicts of interest and accountable for their decisions.
- Relative to the unassisted active choice baseline, assisted employer choice (with employee protections) would:
  - enhance member benefits by increasing the likelihood of members being placed in higher quality products, and reducing the likelihood of them being placed in a poor product
  - promote healthy competition by presenting product providers with incentives to perform strongly against the preferred default list selection criteria or compete for corporate tenders, but there would still be some scope for wasteful marketing to employers
  - increase the potential for agency problems given the involvement of employers, although
    the risk to the *integrity* of the *system* would lie substantially in the appointment process
    for the preferred default list selection panel
  - reduce search costs for employees, while increasing search costs for employers and regulatory costs for funds and government.

This chapter describes and evaluates a model enabling employers to choose any default product offered by an approved provider, subject to that product meeting the minimum criteria imposed by administrative filtering. Although a model of this form is currently used to determine default status, consistent with the approach discussed earlier in the report, the Commission is developing this model, and the other models, as alternative models distinct from the current default determination arrangements.

This chapter first explains why the Commission has chosen this model for assessment (section 8.1). It then discusses how it would work in practice, including the selection criteria applied and other design features of the model (section 8.2), and the supporting institutional arrangements required (section 8.3). Finally the model is evaluated against the Commission's assessment criteria (outlined in chapter 2) relative to the unassisted active choice baseline (section 8.4).

#### 8.1 Why the Commission chose this model for consideration

This model builds on the current regulatory settings which impose a legal obligation on employers to make superannuation guarantee payments on behalf of their employees. Employer involvement in defaults is an extension of those obligations — employers bear a penalty if there is no product into which contributions can be made.

A further rationale for this alternative model stems from the hypothesis that an intermediary — such as the government or an employer — might be better placed to choose a superannuation product than an employee, given the difficulties many employees have making active choices (chapter 4). Involving employers in default product choices can also assist in generating competition and contestability in the sector, particularly where disengaged members would otherwise not exert competitive pressures on product providers.

There are also potential efficiency benefits associated with employers choosing products, such as economies of scale from employers incurring search costs on behalf of many employees, and ongoing reductions in transaction costs for employers by minimising the number of providers they have to deal with.

A number of participants suggested that employers were best placed to choose a default fund for staff, given they were well placed to understand staff needs. For example, Workplace Super Specialists Australia (sub. 11, p. 3) stated:

We believe that the employer is the entity that is best positioned to select the default super fund on behalf of its employees. The employer best understands the culture, demographics and requirements of its own workforce.

AMP (sub. 42, p. 3) stated there were advantages from employer-chosen defaults:

AMP believes that regardless of the size of employer, employer chosen defaults provide significant benefits to employees. The product provider works with the employer to drive stronger member outcomes ... There are also benefits to the employer from their choice of default product. Efficiencies are gained with the ability to select one default product to be used for all employees and to choose a product provider with more efficient administration services and functionality.

Some participants did not consider that employers were well placed to choose default products for their employees. For example, the Australian Chamber of Commerce and Industry (sub. 27, p. 8) said:

There is no particular reason why as a class employers are well placed to identify the best default fund and good reason to suspect that they are not. ... many employers are not equipped to identify the best default, or defaults, for their employees (the make-up or circumstances of which may change over time), [there is the] the principal-agent problem and the fact that the selection of funds is constrained by modern awards.

The Australian Securities and Investments Commission (ASIC) (sub. 41, p. 3) noted that many employers were not well placed to choose a superannuation product:

'Employers' for superannuation purposes will cover a very wide spectrum of organisations and individuals with differing level of financial literacy. While large employers may have dedicated staff, others may be time poor or unaware of the types of issues that can arise in relation to the choice of a default superannuation fund. ... Employees may ... perceive the employer to be more knowledgeable about superannuation ... and interpret the employer's choice as an implied recommendation.

Many smaller to medium sized (SMEs) employers in particular are not well placed to absorb the administrative costs of superannuation and to make choices on behalf of their employees. They may not have sufficient time and resources to effectively guide employees to make good choices, or they may not feel comfortable doing so (box 8.1).

#### Why filter products for employers?

An administrative filter providing guidance to employers on the most suitable products for their employees could assist them in making default product selections. Many employers see default superannuation selection as imposing a significant burden and would appreciate the task being made easier. The Restaurant and Catering Industry Association (sub. 10, p. 1) stated:

Our industry is made up of a large number of small businesses, for whom superannuation is not core business. Like their employees, they do not have the resources or the expertise to devote to selecting quality superannuation funds. For these reasons we support the existing transparent, independent process in which funds are shortlisted by experts based on their performance and other factors.

#### Box 8.1 SMEs and employee superannuation

The industry superannuation fund REST recently commissioned research on entrepreneurship in Australia and superannuation and retirement adequacy. In total 1701 employers from around Australia completed online quantitative surveys in mid-2016 including 184 entrepreneurs, 282 SME owners/managers and 64 sole traders. For the purposes of the study, SMEs were businesses with up to 199 employees.

In relation to SMEs and employee superannuation, the study found that:

- four in five SME owners (82 per cent) and managers (79 per cent) believe that it is the responsibility of their employees to choose the fund that is right for them
- two in three SME owners (68 per cent) and two in five SME managers (39 per cent) surveyed agreed that paying superannuation contributions is a chore and want this task managed as quickly and cheaply as possible
- about four in five SME owners (78 per cent) and two in three SME managers (67 per cent) want to 'do the right thing' by their employees in terms of the superannuation, but there is a limit to how much time and effort they are willing to spend on it.

Source: REST (2016).

An administrative filter also seeks to reduce the potential for bad outcomes for members stemming from principal-agent problems associated with employers choosing products. The Commission has previously identified a number of reasons why employers might not have the incentive to make a decision that is in the best interests of their employees:

- employers do not receive the direct benefits of a well-performing product, and therefore might have little incentive to invest time and effort in making choices that are in their employees' best interests
- employers might choose a product with the least onerous administrative arrangements for the employer
- search costs might be high particularly if choosing from a large number of products, especially where an employer lacks information and expertise
- some funds might have additional benefits specific to employers, such as access to financial products
- employers might be driven by the legal ramifications of their choices, rather than the best interests of members (PC 2012, p. 60).

The Australian Institute of Superannuation Trustees (AIST) (sub. 28, p. 36) saw default product selection by employers as appropriate only after a transparent filter had been applied:

It is appropriate that employers exercise choice of fund from within a range of eligible products. Whilst it is acknowledged that many employers do not have the skills or time or resources to choose from an extensive list of funds, it is appropriate that employers select a fund that after transparent consideration has been deemed appropriate for the general industry or occupation that the employer operates within.

The Financial Planning Association of Australia (sub. 29, p. 8) discussed the advantages and disadvantages of employing a filter:

The advantage of using an administrative filter is that it reduces the cost of selecting defaults because funds that seem obviously inappropriate don't have to be rigorously assessed. The disadvantage is that, without interpretation, there is a risk that temporary characteristics of funds may make them ineligible to be a default fund (at least until the next assessment).

In summary, an administrative filter can assist employers in choosing a default product that is in their employees' best interests by addressing information complexity and asymmetry. Narrowing the range of default options can make choice more tractable for employers (as discussed in earlier chapters, too many choices can be overwhelming), and it can (by imposing minimum standards) protect employees from bad choices by employers while injecting some trustee-level competitive pressure.

## 8.2 How would administrative filters operate?

This section discusses the design and technical features of the proposed model, including broad criteria that could be used to determine the list of eligible default products. While the Commission's model is developed anew, the Commission has drawn on existing features of the MySuper authorisation process and the criteria in the *Fair Work Act 2009* (Cwlth) (Fair Work Act). These provide valuable lessons and reflect relatively recent consultation exercises (including previous work by the Commission). The discussion also draws on the 2010 Cooper Review, the Commission's stage 1 work on developing criteria to assess the competitiveness and efficiency of the superannuation system, submissions to this inquiry and various other material.

## A heavy or light filter, or both?

Inquiry participants generally suggested one of two types of administrative filters:

- The first variation involves the application of a mandatory 'light' filter, designed to eliminate poor quality or underperforming products from the list of eligible products. This variation of the model is effectively a market-based (or decentralised) model, leaving employers with a large degree of discretion to choose default products.
- The second variation of the model involves a 'heavy' filter, which would be designed to ensure employers can choose only from products assessed to be of relatively high quality. This would confine employer choices of default products to a relatively narrower list of options.

In practice, there are pitfalls associated with simple notions of the 'light' and 'heavy' filters operating on a standalone basis, as noted by Industry Super Australia (ISA) (sub. 40, p. 53):

A weak filter that covers the entire system would be of little utility. A strong filter pursuant to which few funds are eligible, and that covers the entire system could result in no appropriate options or an insufficient number of options for certain segments of the population.

PwC (sub. 12, p. 6) noted that the choice could influence perceptions of the government's responsibility for outcomes:

If you apply an administrative model, you are basically saying that any fund that meets this bar is open to being a default fund. For example, this could simply be any MySuper fund as they have already met a certain minimum standard. ... This will likely result in less responsibility for the Government should one of these funds fail, than if you actively try to select a fewer number of "best" on offer through a mixture of quantitative and qualitative tests and one of these funds fail.

The Commission's preferred approach for employer default product selection is the 'dual-list' model: a mandatory light filter determining absolute default product eligibility (a 'mandatory minimum standards list'), and the heavy filter providing employers with guidance about products (a 'preferred default list'). The Commission considers employing such an approach would attain the best features of the light and heavy filters, while also minimising the more negative aspects associated with each when used alone.

To be on the preferred default list, products would be required to meet more stringent selection criteria and higher performance benchmarks. They would also need to be more suitable as default products for the broader population — that is, they would be relatively 'no frills' products with a simple set of features that are easily comparable across products and particularly suited to relatively disengaged members. The default selection process would be designed so that products should primarily compete on long-term net returns and costs for a given level (threshold) quality of service, not on the quality or range of ancillary services offered per se (chapter 3).

The process for inclusion on the preferred default list could be considered in some ways similar to the process discussed in chapter 7 relating to the multi-criteria tender model. However, the process would not require the same tender-style governance arrangements that are designed to accompany a mandatory choice outcome as in chapter 7, and would avoid the cost of a formal allocation mechanism post-tender, with employers playing that allocative role.

## A dual-list approach could help meet diverse needs

Many businesses (particularly SMEs) that lack the expertise or resources to choose a suitable product would prefer a relatively short list of highly suitable products to choose from to simplify their choice, and better ensure that they choose a relatively good product.

Employees of these businesses are therefore likely to benefit from a 'heavier' filter because their risks of being placed in a poorly performing product are diminished.

Many larger employers, on the other hand, are well placed to negotiate good deals for their employees, and might employ methods such as corporate tenders to choose products. Being required to choose from a preferred default list (which is likely to be a relatively small proportion of eligible products) would potentially restrict the capacity of these employers to negotiate good deals (and could compromise the competitiveness of in-house tender processes). Providing the capacity to knowledgeable employers to choose a default product from a longer minimum standards list is therefore likely to promote the best interests of employees and promote competition.

The Commission envisages that the preferred default list would, over time, be populated by relatively generic products suitable for all employees. It is likely that some employees, based on their workplace or occupation, would benefit from products not contained on the preferred default list, and that some providers would only be seeking a segment of the default market. It would therefore be important to ensure flexibility to provide employees with the best outcomes.

UniSuper (sub. 20, p. 9), for example, noted it has previously only applied for its MySuper product to be listed in higher education awards. Whether or not it was included on the preferred default list, UniSuper should be free to offer its products as defaults, and tertiary sector employers should still be free to choose them, provided the products continued to meet the light filter.

The dual-list approach would also promote competition and drive improved performance as some funds contained on the mandatory minimum standards list would be likely to compete for their products to make the preferred default list.

The Commission is also supportive of a dual-list approach in this form of model because it would be one way to avoid capping the overall number of listed products while still providing a relatively high level of filtering for employers that preferred this. It would effectively make the 'cap' standard based. CHOICE (sub. 31, p. 15) expressed support for a standard-based approach:

... a cap on the number of qualifying products which is too low may unnecessarily limit competition. It would be better to base the system on a standard which products must meet, then progressively lift this standard in an attempt to drive competition.

Arbitrarily capping the number of products that could potentially be listed could impose artificial constraints on competition and restrict access to default products that might benefit particular employees.

There is, however, a case for specifying a *minimum* number of products to be included on the eligibility list under the heavy filter in order to ensure meaningful competition and that incumbent funds do not take their membership base for granted.

In summary, the Commission considers that given the diverse needs of individual employers and employees, a 'dual-list' approach, incorporating the use of both light and heavy filters, is likely to provide the best outcomes under the assisted employer choice (with employee protections) model.

- A mandatory light filter would be used to determine eligibility to be chosen by any employer as a default product (a 'mandatory minimum standards' list), while a heavier filter, applying stricter criteria and employing higher performance benchmark hurdles, would identify a narrower 'preferred default' list of the best performing products as additional 'opt in' guidance for some employers. The preferred default list would also focus on 'no frills' products with higher suitability for default members.
- Maintaining an optional preferred default list would help SMEs to choose a good, highly suitable product. Maintaining a broader mandatory minimum standards list would provide employees with a safeguard against very poor choices by their employer, while giving well-equipped employers flexibility to negotiate good deals for their workforces.

## How could it be ensured employers acted in good faith?

A number of stakeholders expressed concern about employers either being subject to inducements from product providers, or choosing a product not in the best interests of employees because of benefits to the employer (concerns which would be exacerbated in a model providing employers with a high degree of freedom to choose products). For example, AIST (sub. 28, p. 24) stated:

We are concerned the problem of direct and indirect inducements to employers is a clear market impediment. We note that this is a contentious subject where proof is often difficult to obtain. Commercial incentives and sales pressures have not been removed from the system. There is a need to examine evidence of principal-agent issues in default fund selection, including any possible direct or indirect incentives provided to employers.

ASIC (sub. 41, p. 2) noted there were no current requirements for an employer to select a fund that is in the member's best interests:

Although employers currently have the legal responsibility to make a decision in relation to the default superannuation product, employers are required to neither select a fund that is in the best interests of their employees nor to put their employees' interests ahead of their own in selecting the fund.

However, there are existing regulatory prohibitions on providers offering inducements to employers on the condition that their employees join the fund. Section 68A of the Superannuation Industry (Supervision) Act 1993 (Cwlth) (SIS Act) currently prohibits such inducements, although contravention only gives rise to the possibility of future civil action by aggrieved individuals (ASIC, sub. 41, p. 3).

To a significant degree, a well-calibrated and enforced mandatory minimum standards filter would provide a safeguard against any mal-intentioned behaviour by employers, and this is the most effective mechanism to address those risks. However, whenever it falls on employers to choose default products there is an inherent risk some will not act in the best interests of their employees. There is also an inherent risk of inertia, where employees might be left in products that are not ideal for their needs. Attempting to prevent these problems entirely through regulation would impose a large red tape burden on employers. As such, the potential for principal–agent problems remains a residual risk under this model.

The Commission has considered and decided against several options for imposing additional duties on employers (because, as explained below, this is unlikely to be the best way to deal with the inducements issue).

The first relates to employees being able to take legal action in the event that employers make poor default product choices. Legal action against employers over various aspects of pension plans is relatively common in the United States (box 8.2), but not in Australia. With a mandatory minimum standards filter in place, the Commission does not see it as purposeful that employers should be subject to subsequent legal action for choosing a product within that filter. In the 2012 inquiry (PC 2012, p. 175), participants raised concerns that a risk of legal liability for employers if they choose a product which in hindsight turns out to be unsuitable might prevent employers from exercising any degree of discretion at all. This is reinforced given that employees in defaults will generally have not taken the option of exercising their own choice, preferring to defer it to their employer.

The Commission is also not attracted to softer options that involve mandatory employer disclosure to their employees of reasons for choosing a particular fund and of not having any unresolved conflicts of interest. It is unlikely that such requirements would serve an effective purpose, and they could lead to perverse outcomes. A genuinely mal-intentioned employer might be seen to have complied fully with the letter of their requirements (with no adverse consequences). Conversely, another employer making a wholly explicable choice that nevertheless led to bad outcomes due to factors outside their control could incur a liability of uninsurable value. As discussed earlier, the Commission anticipates that some employees would benefit from their employers shopping around and tailoring products for their workplaces. From both a competition and stability perspective in this model, it would also be important to ensure products not on the preferred default list did not have their viability excessively compromised by ill-considered regulations.

#### Pension plan related legal action against employers is Box 8.2 relatively common in the United States

Under US law, employees are able to take legal action against their employers (as their retirement plan administrator or fiduciary) for not acting in employees' best interests in accordance with 401(k) plans. Section 404(a) of the Employee Retirement Income Security Act 1974 (US) (ERISA) requires fiduciaries to discharge their duties with respect to a plan solely in the interests of participants and their beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable administration expenses. Legal action can include matters such as appealing denied claims for benefits and recovering benefits owed, clarifying rights to future benefits, accessing retirement plan documents and to address breaches of fiduciary duties.

Over the past decade, a significant number of lawsuits have been filed in the United States against retirement plan sponsors for failing to properly administer plans. Allegations have included a failure to monitor excessive fees, directing employee savings toward affiliate-overseen investment products, and favouring more expensive retail mutual funds over less costly alternatives. Employers are exempt from fiduciary liability if employees are provided with individual investment options under a pension plan and given sufficient opportunity to exercise control over assets in their account (ERISA, s. 404(c)). Essentially this provides a 'safe harbor' for plan fiduciaries where plan participants self-direct their investments, ensuring employers won't be legally responsible for their employees' investment mistakes.

Sources: FindLaw (2016); Shepherd Smith Edwards and Kantas (2015).

Finally, some participants have also suggested a 'better off overall test' (BOOT) could be employed either in conjunction with an administrative filter, or as an alternative to employing one. The Commission's view is that a BOOT is not a satisfactory alternative to an administrative filter (box 8.3). Further, such an approach would be unnecessary with a dual filter as the latter would be designed to safeguard employee interests, while also providing employers with a reasonable level of flexibility.

Ultimately, it is implausible to impose an obligation on employers to act in their employees best interests, not least because the best interests of employees are likely to vary (sometimes significantly) across the workplace, and employers cannot know what they are (especially given they are typically not superannuation experts). Rather, the most effective way of ensuring employers' actions are consistent with the best interests of employees is to place obligations on superannuation fund trustees (that is, to ensure inducements are not offered in the first place). Providers should be prevented from offering employers inducements (including preferable deals on non-superannuation products) to choose their products as defaults, and regulators should actively enforce this. The Commission considers the existing provisions in the SIS Act, and their enforcement, would require strengthening if the model presented in this chapter were to be adopted.

## Box 8.3 Could a measure such as a 'better off overall test' be an alternative to a filter?

One option for allocating default products, either as an alternative to a filter or in conjunction with it, would be the imposition of a 'better off overall test' (BOOT) as is often applied in other areas of workplace relations. Effectively, it would mean that an employer could remain with their existing product or switch to a new default product provided an independent decision maker determined that this arrangement would, on balance, leave employees better off overall than previous arrangements.

A BOOT would be less straight-forward on an issue such as superannuation fund choice relative to other areas of industrial relations because future returns cannot be known with certainty and the respective merits of products could be contentious.

The Commission's 2012 default superannuation inquiry (PC 2012) considered the merits of employing a BOOT-style arrangement. Concerns raised about this proposal included that such a test would not necessarily cover a situation where the majority of employees might be better off but some worse off, that it could be burdensome for employers to demonstrate the test had been met, and that employers would not necessarily know for certain whether employees would be better or worse off. It was also suggested employers might be reluctant to use such provisions (which might require employers to obtain legal or financial advice).

#### What would the selection criteria be?

A key aspect of administrative filtering is determining the selection criteria for both the mandatory minimum standards and the preferred default list.<sup>30</sup> A number of participants suggested that the current criteria employed by the Australian Prudential Regulation Authority (APRA) when granting MySuper authorisation represented a suitable mandatory minimum standards filter (box 8.4). Reliance on these criteria would effectively mean that all authorised MySuper products would be eligible to be chosen as defaults.

<sup>30</sup> This discussion is similar to that in chapter 7 regarding assessment criteria under a multi-criteria tender model.

#### Box 8.4 Would allowing any authorised MySuper product represent an effective minimum standards filter?

A number of participants suggested that the existing MySuper authorisation process represented an adequate minimum standards filter to ensure employees were being placed in a quality product. For example, Colonial First State (sub. 25, p. 1) said:

Given the rigorous and costly process of designing MySuper products and then achieving APRA authorisation, we believe this is the simplest and most effective framework for default arrangements in the future.

#### AMP (sub. 42, p. 2) expressed a similar view:

The competitive process to determine which products are eligible to be defaults should be based on APRA's strict requirements for a MySuper licence and consistency and transparency of product information provided. All compliant MySuper products should therefore be able to compete equally as default products eligible for selection. An open market with employer choice will put pressure on incumbent funds to compete, which will result in continued downward pressure on fees, increased product innovation and therefore better outcomes for members.

APRA (sub. 33, p. 2), however, suggested the current authorisation criteria need strengthening:

... both the current legislative MySuper authorisation criteria and the scale test could be strengthened with a view to MySuper products being of overall better quality. ... since 1 July 2013, there has been considerable variation in net returns and fees for different MySuper products, leading to a wide range of outcomes ... While there has been some evidence of reductions in fees and costs since MySuper products were introduced, particularly for products with previously very high fee levels, there is clearly room for further improvement. Further, while many MySuper products have achieved their net return targets over the past few years, some have fallen well short.

Australian Super (sub. 19, p. 4) raised issues about the suitability of the current MySuper authorisation process for use as a minimum standards filter:

The MySuper licensing regime has no direct filter to prevent long term low performing funds from becoming default funds, or ceasing to be default funds.

The Corporate Super Association (sub. 35, p. 2) also expressed concern about opening the selection process to 'any MySuper' product:

... we understand that many of the default funds currently used, particularly in the not-for-profit sector, have been performing very well in services and investment, whilst there are MySuper products in the wider market that do not perform so well ... To open the market to every MySuper fund provides employees and small employers with decisions they may be ill-equipped to make ... The outcomes may end up worse than in the existing default system.

A number of participants suggested ways in which the existing MySuper authorisation criteria could be strengthened to make them more suitable for use as a minimum standards filter. For example, the Financial Services Council (sub. 38, pp. 22-23) suggested that scale, fees and long-term net investment returns should be the main criteria for assessing products, together with ancillary criteria such as capital adequacy, governance and whether income stream products are offered in retirement. The Financial Services Council also suggested the Australian Government should benchmark fees and net returns for MySuper products, and that products seen to be performing poorly over the medium-term could have their MySuper authorisation revoked (after APRA worked with trustees initially to determine the reasons for underperformance).

Many other participants suggested the criteria employed currently by the Fair Work Commission (FWC) (or some variation of these criteria) to determine the eligibility for MySuper products to be included in awards represented a good basis for developing selection criteria. Some other participants simply listed those factors they considered should be applied without reference to the MySuper authorisation or FWC processes.

In its 2012 Default Superannuation inquiry, the Commission did not support moving to an 'any MySuper' filter to determine eligibility for default status due to concerns about the likely variations in the quality of MySuper products that would be offered initially, the inherent principal—agent issues between employers and employees, and the stated lack of interest and expertise on the part of many employers when it comes to choosing a default product. The Commission did not rule out in 2012 the current MySuper authorisation criteria filter defining suitable minimum standards for default eligibility in the future if the average quality of MySuper products increased over time and there was an observed narrowing in the quality differential between them. However, these circumstances have not eventuated. APRA (box 8.4) has noted there is still 'considerable variation' (sub. 33, p. 2) between the performance of MySuper products, and many have failed to achieve their target returns. Further, there have been questions raised by some commentators about the long-term viability of some products exhibiting net outflows (Boyd 2017).

The Commission's 2012 report proposed additional non-prescriptive criteria for default status eligibility on top of the MySuper authorisation criteria. The Australian Government subsequently legislated criteria for the FWC to consider when determining eligibility to be listed in awards (box 8.5) that were largely based on the Commission's recommendations.

One criterion included in the current process that requires reconsideration is insurance. As discussed in chapter 3, there are challenging trade-offs in considering the merits of default superannuation products, without also considering insurance products. The criteria applied for both lists in the administrative filter should relate to the superannuation product only. This would ensure that the filter was consistent with the proposed objective of superannuation, where insurance has at best only an indirect relevance to that objective.

Clear rules for minimum standards of insurance product quality and level of cover should be determined separately by regulation. Decision makers should then ensure these regulated standards and levels of cover in the selected default products are delivered by products that make it onto the filter.

#### Box 8.5 Current criteria for default products in awards

Following the recommendations from the Commission's 2012 Default Superannuation inquiry, the Australian Government introduced a quality filter in the Fair Work Act 2009 (Cwlth) for products that would be eligible for inclusion as defaults in modern awards. Under section 156F of the Act, the Fair Work Commission is required to compile a 'Default Superannuation List' on the basis of a set of criteria, which include:

- 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
- the appropriateness of the fees and costs, given:
  - its stated long-term investment return target and risk profile
  - the quality and timeliness of services provided
- the net returns on contributions invested in the MySuper product
- · governance practices, including mechanisms to deal with conflicts of interest
- appropriateness of insurance offered in relation to the MySuper product
- quality of advice given to a member
- the administrative efficiency of the fund.

The Fair Work Commission may also consider any other factors considered relevant. As a consequence of a Federal Court decision, the Fair Work Commission has been unable to conduct the review of default superannuation funds. It is awaiting new appointments to its expert superannuation panel (FWC, sub. 51).

The Commission's 2012 report also emphasised that judgment would be required to weigh the importance of each criterion, to determine whether to limit selection criteria to those mentioned in legislation or include others, and to assess which criteria best respond to the characteristics and needs of the employees covered by each award (PC 2012, p. 134).

The Commission has also considered criteria developed for similar default selection processes elsewhere in the world (appendix B). The KiwiSaver criteria applied in New Zealand (box 8.6) notably incorporate a number of measures relating to size, capacity and track record of institutions (including a 'corporate strength' criterion). Some commentators in New Zealand (Littlewood 2012) have suggested this has led to choices that might be 'safe' for the NZ Government rather than choosing providers that are necessarily focused on the best interests of members.

#### Box 8.6 Selection criteria for KiwiSaver default providers

In New Zealand, selection of KiwiSaver default providers is via a multi-criteria tender. However, the criteria used could apply equally to an administrative filter. The current criteria can be summarised as:

- investment capacity includes a track record of capability and performance, the ability to meet the NZ Government's default specifications, and the ability to offer a full range of KiwiSaver funds in addition to the default
- 2. corporate strength a reputable organisation with sufficient financial capacity and infrastructure
- 3. administrative capability able to process a large number of transactions, and flexible enough to respond to frequent changes
- 4. track record and stability commitment to accept the KiwiSaver default mandate and to carry it out at the fees agreed
- 5. investor education and advice the ability to provide investor education and impartial financial advice, including to proactively contact default-enrolled members to ensure they are invested appropriately.

Source: NZCO (2013).

#### The Commission's proposed criteria for filtering products

The current MySuper authorisation process *in principle* provides a good basis for a 'light' minimum standards filter. However, as noted above, there are some weaknesses with the current process. Data indicate that since implementation in 2013, there has been considerable variation in net returns and fees for different MySuper products, leading to a wide range of outcomes for members across these different products (APRA, sub. 33, p. 2). The Commission considers that *strengthened* MySuper authorisation criteria would be a suitable basis for a mandatory minimum standards filter.

In particular, the Commission considers the minimum standards filter criteria should consider the performance of products to a greater degree than the current authorisation process does. Funds should be required to self-report against predetermined targets, with this self-reporting to be backed up through independent auditing by, or on behalf of, APRA. Products displaying persistent underperformance against their targets should be excluded from default eligibility. Product providers considered unlikely to meet their trustee obligations should be similarly excluded.

The current legislated MySuper authorisation process deals with these matters to a degree. However, the process for removing authorisation of poorly performing products is convoluted and difficult and the consequences of such removal for existing members have not been articulated by Government or the regulators. The Commission sees this as failing to ensure default members are in products of a reasonably high standard. The imposition of an enhanced minimum standards filter is a better way of ensuring this.

The current scale test employed under MySuper also appears to have had little impact, particularly in view of barriers to fund mergers (such as bulk transfer rules). To meet the Commission's proposed minimum standards filter, providers would have to demonstrate — and have independently verified — that scale was not an impediment to their performance. The Commission intends that this not be a cursory review.

The Commission also assessed the current legislated criteria contained in the Fair Work Act, and the modifications suggested by participants. On balance, the Commission has concluded the current Fair Work Act criteria provide sufficient coverage of relevant considerations, and represent an adequate basis for developing the heavy filter to determine the preferred default list. However, consideration could be given to refining some of the language around the criteria, such as the use of the word 'appropriate' which would not provide sufficient guidance to the decision maker.

The Commission envisages that to qualify for the preferred default list, products would need to be considered the *most suitable* for default members in view of their 'no frills' nature, and would need to exhibit high governance standards and consistently superior performance relative to rival products in delivering long-term net returns to members. It is expected that inclusion on the preferred default list would be difficult to achieve.

A comparison of how the Commission's proposed criteria for filtering products relates to the current MySuper authorisation process is contained in table 8.1. Product providers would be required to self-report against criteria on an ongoing basis under both the mandatory minimum standards list, and the preferred default list.

Many of the suggestions for additional criteria raised by stakeholders are factors the Commission assumes would be taken into account by the relevant decision maker under the proposed criteria. Many of these areas are also covered by separate legislation with which superannuation funds are required to comply.

Table 8.1	Comparison of My	Super and administra	tive filter criteria
Characteristic	Current MySuper authorisation process	Mandatory minimum standards criteria	Preferred default list criteria
Need for accreditation	Funds must obtain MySuper authorisation to receive default contributions	Funds <i>must</i> comply with minimum standards criteria to receive default contributions	Voluntary for funds
Accumulation product features	Simple set of core services including administration, investment and intrafund advice	Must include core services. Limited to products considered <i>suitable</i> for default members, with relatively homogenous and easily comparable 'no frills' features	Must include core services. Limited to products considered the <i>most suitable</i> for default members, with intuitive, effective and easily comparable 'no frills' feature
Investment strategy	Single diversified strategy or set of life-cycle strategies	Same as MySuper	Single diversified strategy only
Fee structure	MySuper product can be offered at a single price or fee structure, or at different prices	Same as MySuper	Same as MySuper
Investment fees	Investment fees can include a performance-based fee subject to limitations	Same as MySuper	Same as MySuper
Exit and switching fees	Limited to cost recovery	Same as MySuper	Same as MySuper
Commissions a	Prohibited	Prohibited	Prohibited
Investment performance	Funds must report return and risk targets, but no specific performance standard	Products that persistently underperform (over multiple years) relative to pre-stated targets to be excluded	Products must demonstrate consistently higher performance relative to the average of all other default products
Fund scale	Funds must demonstrate that the scale of the fund does not disadvantage members relative to members of other MySuper products	Funds must regularly demonstrate, and have independently verified, that fund scale is not an impediment to performance	Same as minimum standards criteria
Governance standards	Funds must be likely to comply with trustee obligations	Same as MySuper	Funds must demonstrate consistently high governance standards and evidence of meeting trustee obligations
Insurance	Life cover and total and permanent disability cover must be provided on an opt- out basis	Insurance offered as part of default product must meet minimum regulatory standards (chapter 3), and details must be clearly and accessibly disclosed	Same as minimum standards criteria

 $<sup>{</sup>f a}$  Paid by trustees or fund providers to financial advisers or third parties.

Sources: Australian Government (2011); Superannuation Industry (Supervision) Act 1993 (Cwlth).

# Should there be multiple lists segmented by industry or occupation, or a single approach for the entire workforce?

Historically, the Australian system for allocating defaults has been linked to awards, meaning lists of available default funds have varied across industries and, to some degree, occupations (chapter 1). The question is whether maintaining a segmented approach with multiple lists is warranted for the alternative model outlined in this chapter. A number of participants commented on this (box 8.7).

#### Box 8.7 Participant views on whether lists should be segmented by industry or occupation

ISA (sub. 40, p. 29) suggested there were good reasons to differentiate default allocation by

... there are good reasons for allocating different kinds of workers not just to different kinds of products, but also to different providers. Different workers operate under different employment conditions and environments. For example, although impersonal or electronic communication-based approaches are perhaps the norm, it remains the case that some workers are on ships, or in other remote worksites. Providers that are familiar with and connected to industries can and do accommodate industry-specific needs in ways that a generic provider cannot ...

The Corporate Super Association (sub. 35, p. 7) expressed concern about having only one filter:

[The CSA] would be concerned about a single filter covering the entire system. Not every work force has the same needs. It would be prejudicial to use the same assessment tools in respect of everyone ... homogeneity needs to be avoided in superannuation.

AMP (sub. 42, p. 2) pointed to benefits of enabling employers to consolidate default accounts across a workplace:

Product providers can work with the employer to tailor services to their workforce, such as education seminars and advice services which encourage positive member actions including consolidation of superannuation accounts. Consolidation can result in significantly higher average balances ...

ASFA (sub. 24, p. 9) noted that even if products are tailored towards cohorts of workers, this is still very different to tailoring them towards individual workers:

By construction, tailored products for each cohort, based on a set of assumptions, would be tailored for the 'average' individual in each cohort, not to the range of individuals. This means that not all members would be allocated to the product that bests suits their circumstances.

The Australian Chamber of Commerce and Industry (sub. 27, p. 11) noted the current system can lead to account proliferation.

On one hand, there are likely to be variations for some groups across the workforce that would mean they could benefit from tailoring of products, such as young people (who would typically benefit from higher risk investments), or construction workers (to whom some insurance might be more important). However, these benefits appear on closer examination to be limited to relatively few segments of the workforce (and are also largely related to insurance offerings attached to the default product, rather than the default superannuation product *per se*). Linking defaults to awards has enabled this specialisation and ensured a default system when none was otherwise available.

But today, 25 years after the inception of a relatively low rate of super contribution (3 or 4 per cent depending on employer size) Australia has a system with in excess of three times that original minimum level as a proportion of earnings and with wider workforce coverage. The ability to innovate and constantly reflect on performance is a matter primarily left to trustees and superannuation fund management. However, with guaranteed inflows under some industrial agreements, the incentives are not as strong as when a fund is reliant on competing openly for members. And innovation, especially in investment strategy, matters, particularly with lower growth outlooks being the new reality in the western world. With the Australian superannuation system now exceeding \$2 trillion and growing rapidly through compulsion and tax incentives, relying on good intentions — evident though they are — and trustee standards, may not be sufficient to see ongoing and meaningful innovation. Default members, many of whom are very disengaged, are most at risk of failing to observe a lack of innovation until late in life, possibly too late.

Currently employers with staff employed under different awards might be compelled to place staff in a range of default products due to differences in product eligibility across awards. Varying default eligibility based on awards, or an alternative mechanism, can therefore make it difficult to obtain benefits that could accrue to members (and employers) from having products selected as tailor-made for default members.

On balance, one single 'minimum standards list' and one 'preferred default list' across the workforce would likely be sufficient. Those industry-based funds that specialise in default members are generally well-placed to meet the minimum standards filter requirements, and on most criteria should be able to readily adapt to potentially meet requirements of the preferred default filter. While individual default products that maintain an element of specialisation might be particularly suitable (or unsuitable) for specific employee cohorts (characterised either by age or occupation), having employer choice enables those products to be developed and selected.

Related to the question of tailoring is the question of how corporate superannuation funds would be dealt with under an administrative filtering model. The Corporate Super Association (sub. 35, p. 2) noted the exclusion of corporate funds from default arrangements could adversely affect some employees.

The retention of corporate funds as default funds in awards, including the retention through grandfathering, has been the result of ... bargaining and negotiations. To exclude these funds from awards would result in significant adverse effects for employees because many provide benefits that exceed [superannuation guarantee] minimum, ... tailored ... insurance arrangements, and are otherwise generously supported by the employer-sponsor ...

The Commission agrees that arrangements for corporate funds (or defined benefit arrangements) can be relatively favourable to workers in many cases. In principle, there

should be no impediment to corporate funds being eligible as default products provided they meet the criteria for the minimum standards list.

For both industry funds and corporate funds, the scale test may be the real challenge and, as noted earlier, the ability to demonstrate a capability to sustain performance is intended under the filters to be a more robust test than it has proved to be until now.

#### Institutional arrangements 8.3

# Who would apply the filters?

Under current arrangements, APRA undertakes MySuper authorisation and the FWC<sup>31</sup> determines eligibility for listing in awards. The role given to the FWC reflects that superannuation entitlements have largely emerged from the workplace relations system and that choice of fund has been a key focus of industrial parties (chapter 1).

As discussed in chapter 3, the Commission considers an organisation suited to selecting default products would possess the following characteristics:

- an obligation to act in the best interests of fund members
- an understanding of the needs of default members and how these are best met
- sufficient expertise and knowledge of superannuation and finance
- transparent processes
- procedural fairness (that is, enabling all relevant parties to participate equally)
- be dispassionate and free of conflicts of interest
- be accountable for its decisions such that, in the presence of poor process or unanticipated but evident conflict, Ministerial ability to cease a process and/or replace a panel remains a sanction readily available.

Some participants have suggested APRA as a suitable body. APRA (sub. 33, p. 5) itself has suggested that, as the prudential regulator for the entire industry, this would not be a suitable role for it:

As the prudential regulator for the superannuation industry, and given our role in authorisation of MySuper products offered by RSE [registrable superannuation entity] licensees, APRA is a key stakeholder in the development and implementation of any default allocation model. ... However given APRA's broader role in relation to the superannuation system, it would be inappropriate for APRA to have any decision-making role in relation to the selection of a sub-set of MySuper products that may be eligible default funds under any default allocation model.

<sup>31</sup> As a consequence of a Federal Court decision, the FWC has been unable to conduct the review of default superannuation funds. It is awaiting new appointments to its expert superannuation panel (FWC, sub. 51).

ISA (sub. 40, p. 33) also suggested a role in default product selection could conflict with APRA's prudential regulation role:

... adding default fund selection to the responsibility of one of the financial services regulators in Australia would be inconsistent with the "twin peaks" model. The "twin peaks" model, which separates conduct regulation and prudential regulation, is based on the Tinbergen principle, which requires focused instruments of policy. Adding a new policy goal – default super fund selection – could place tension on the regulators' capacity to perform their core mission.

The Commission shares this view to a degree. In order to be seen to be treating all funds equally from a prudential regulation perspective, it is important that a prudential regulator is not involved in making relative quality judgments to avoid any perception that those products nominated as suitable defaults are 'backed' by the regulator and regulated differently to others. In short, APRA would be unsuitable for applying the heavy administrative filter for the preferred default list.

The more subjective the decision, and the closer it is to picking winners and losers, the greater is the case for a specialised Ministerially-accountable process. And the harder it is for an independent regulator to then fill that role.

APRA would be potentially more suitable for enforcing the mandatory minimum standards, in the same way it already does with MySuper. However, to ensure APRA was a suitable body for this purpose, the criteria employed would need to be relatively objective and not require subjective judgements about the relative merits of products.

The role equivalent to compiling the Commission's proposed preferred default list is currently undertaken by the FWC, following advice from a Default Superannuation Panel.

At best, the justification for the Panel's location within the FWC is that awards specify default funds. In other respects, the FWC, as currently constituted, is ill-suited to the role. As in some of its other functions, the FWC's capacity to make merit-based assessments of default funds is limited because it does not have the in-house expertise to deal with the issues. Moreover, the FWC's decisions have generally been based on precedent and the generally harmonious representations of unions and employers in favour of the status quo (PC 2012).

The Commission has previously commented that the process of making appointments to the FWC as a whole is in need of reform to ensure that the decision makers are expert and impartial (PC 2015b). Such a capability would be essential in any default superannuation system that determined default products on merit. Reforms would thus be an essential precursor for any ongoing FWC role in superannuation. In particular, the appointment and accountability structures would need significant adaptation. These are discussed below.

## How should those applying the filters be appointed?

Any entity given the task of determining default selection has the same problem: those people with the expertise required to undertake default selection are likely to have been involved in the financial services industry and may at times then be perceived to have potential biases or conflicts of interest. The only practical offset to this (other than to perversely favour appointees with weak capabilities) is to adopt the relatively simple (if somewhat brutal) strategy of ensuring that the panel is accountable to a Minister such that poor process or evident (real or perceived) conflict can be dealt with immediately and in a manner that leaves no doubt about integrity. Existing structures (the FWC, as above, but also APRA or ASIC) are designed largely to promote independence and consequently do not incorporate this accountability to ministers.

The Commission's 2015 Workplace Relations report recommended that Australian, State and Territory Governments create an expert appointments panel which would provide a merit-based shortlist of candidates for the appointment to the FWC (and the proposed Workplace Standards Commission). The Australian Minister for Employment would then make appointments from the shortlist, where they were satisfied the person was sufficiently unbiased and credible, for a fixed term (box 8.8). The involvement of multiple jurisdictions (for example, the process to appoint the Australian Competition and Consumer Commission Chair) encourages a focus on quality appointees. Although the appointment model was designed for a larger purpose, it still fits this process as well.

The same principles would apply to any alternative body given the task of determining eligibility for preferred default status, except that the Australian Treasurer should be the responsible Minister.

The Commission envisages the panel determining eligibility for preferred default status would meet only for the period it was required and then cease operations. Its decisions about listing could provide significant commercial advantages to providers with products included on the preferred default list, and the Commission considers it should therefore be established as a statutory decision-making body. Decisions about inclusion on the preferred default list would be made by the panel and its decisions would be made public. The Minister would have powers to request the panel to review its decision, to initiate a new review before the term of the current preferred list expires, or to disband the panel at any time. However, the Minister would not have direct powers to change the decision of the panel once it is finalised and announced.

# How often should the list of eligible products be updated?

Based on the discussion in the Commission's issues paper for this inquiry (rather than in direct response to the detailed model proposed in this chapter), participants expressed differing views on the frequency with which lists of eligible products should be updated. The Association of Superannuation Funds of Australia (ASFA) (sub. 24, p. 5) noted the trade-offs regarding the timing of running the process:

Greater frequency of running the filtering process could improve the flexibility and accuracy of the filter, as well as increasing competition and the opportunity for new products to qualify. However, this would need to be weighed against higher compliance and administrative costs, reduced certainty for funds and employees, and potentially placing an unhelpful emphasis on short-term performance.

# Box 8.8 The Commission's 2015 Workplace Relations Framework report

In its 2015 Workplace Relations Framework report, the Commission noted history and precedent play too big a role in some of the Fair Work Commission's (FWC's) key economic and social functions, particularly award determinations. The Commission also noted the FWC's practices tend to give greatest weight to the evidence put by contesting parties, rather than on better evidence that it has actively sought.

The Commission therefore recommended the Australian Government create a separate institution — the Workplace Standards Commission — to undertake wage determination, with most of its members to have professional capabilities in economics, the social sciences and commerce, with legal experts primarily used to ensure enforceable awards. The Commission envisaged the Workplace Standards Commission would proactively undertake its own data collection and systematic high-quality empirical research as the key basis for its award decisions and wage adjustments.

The Commission recommended the FWC continue to be responsible for its pre-existing quasi-judicial functions, such as hearing matters relating to unfair dismissals and various administrative functions, such approval of agreements, right of entry and authorisation of protected action ballots. The processes for appointing members to the FWC should be reformed (with these reforms to also apply to the Workplace Standards Commission). The Commission recommended Australian, State and Territory governments create an expert appointments panel, which would provide a merit-based shortlist of candidates for the two bodies.

The Australian Minister for Employment would then choose members from the shortlist for a fixed tenure. Both the panel and the relevant minister would need to be satisfied that a candidate for appointment had (and was seen to have) an unbiased and credible framework for reaching conclusions and determinations. Appointments would be made for a period of ten years, or to the age of 70, whichever comes first, with no reappointments beyond this term.

Source: PC (2015b).

#### APRA (sub. 33, p. 3) said:

Depending on the nature and frequency of the default allocation process, RSE licensees may be encouraged to adopt a more short-term, narrow focus with respect to investments and product features and their associated costs. Superannuation, by its nature, is a product where the long term financial interests of members should be central to decision making by RSE licensees. ... a regularly repeating competitive default allocation process under which there is a relatively short period of exclusive or shared default status may discourage [long-term] investments. It would clearly be undesirable if the default allocation model did not align with, or even undermined, RSE licensees' meeting their obligations in relation to achieving adequate retirement outcomes for members over the long term.

A number of participants noted the trade-off between the need for stability and the potential benefits from a competitive process. Frequent updating of the list could also encourage short-term performance targeting by funds which may be inconsistent with the long-term interests of members given the nature of the superannuation product.

In weighing up these factors, as discussed in chapter 3, the Commission considers the process of compiling the preferred default list should be undertaken every four years, based on a strictly long-term performance focus. That is, inclusion on the list should be based on performance over the long-term (preferably ten years or more).

The determination of the mandatory minimum standards list should be ongoing (again, based on long-term performance). APRA would routinely monitor governance standards and compliance with trustee obligations. Product providers failing to meet trustee obligations would have their products removed from both the minimum standards list and the preferred default list when this failure becomes apparent, rather than several years later.

The Commission considers it might be worth reviewing the criteria about 10 years after their commencement to ensure they are still fit for purpose. However, beyond this the Commission does not think there is a strong case for regular reassessment.

The key features of the proposed assisted employer choice (with employee protections) model are summarised in table 8.2.

#### 8.4 Evaluation of the model

This section is an assessment of the costs and benefits of the model against criteria relative to the baseline (unassisted active employee choice).

#### Member benefits

As discussed in other chapters, members' best interests are met where long-term net returns are maximised and employees are allocated to the products that best suit their needs (chapter 2).

Employer choice could improve outcomes relative to the unassisted active choice baseline if employers were better placed than employees to choose a default product. Some employers will have relevant expertise or the ability to run a corporate tender, while others might have neither the expertise nor incentive to choose wisely on behalf of their employees. However, employer choice introduces principal-agent issues between employers and employees that are not at play under the baseline.

By restricting or influencing choices, filters lead to more employees being placed in better products, whereas the unassisted active choice baseline relies on employees making this choice for themselves when they might not be well placed to do so. The model should,

therefore, lead to better outcomes for members than would be achieved under the baseline, although the improvement in member benefits stems more from the application of the filters than from employers making choices.

Table 8.2	Summary of key features of assisted employer choice (with
	employee protections) model

Main design elements	Design features
Dual-list approach	Apply both 'light' and 'heavy' filters to develop a mandatory minimum standards list and a shorter 'preferred default' product list to help employers reduce search costs, while also driving competition.
	Preferred default list would employ stricter criteria and higher performance benchmark hurdles. It would focus on 'no frills' products with higher suitability for default members.
	No cap on the number of eligible products listed but consider mandating a minimum number for the preferred default list.
	Employers maintain flexibility to choose any product from the mandatory minimum standards list.
	Only one minimum standards list and one preferred list applied across the entire workforce for simplicity.
Assessment criteria	Long-term investment return target and risk profile.
	Expected ability to achieve target.
	Comparison of fees and costs against benchmark.
	Governance practices.
	Quality of service/advice.
Institutional and governance arrangements	Panel appointed with relevant expertise and knowledge to assess preferred default status. Focus on best interests of members.
	Determination of minimum standards list to be ongoing.
	Preferred default list to be compiled every four years.
	Both lists subject to revision at any time where necessary.
Transparency and accountability	All funds seeking to have products listed as preferred defaults apply with submissions made publicly available.
•	Decisions of panel clearly articulated and transparent.
Ongoing enforcement and reassessment	Ongoing monitoring and enforcement of minimum standards for fund performance by APRA.
	Annual self-reporting by fund trustees backed up by independent auditing by, or on behalf of, APRA.
	Periodic review of the criteria to assess default status (every 10 years).

The use of selection criteria relating to returns, fees and governance also provide incentives to lift performance in these areas. These incentives are less strong in an unassisted active choice world as, without the aid of filters, many employees might not have the capacity to interpret elements of risk and return, understand fees or governance arrangements, and make investment decisions based on this information.

But it may not be a major difference: funds may pay less attention to benchmarks if there is no guarantee of a reward through achieving preferred status, as happens under the assisted employer choice (with employee protections) model.

A potential benefit (albeit possibly minor) of employer chosen defaults, relative to an unassisted active employee choice world, is that some employers (for example, those facing high labour or skills demand) may have an incentive to work with approved default product providers to tailor services to their workforce, including information and advice. This would include encouraging employees to consolidate products where possible.

## Competition

Administrative filters may at first be perceived as more likely to constrain competition than the baseline because filtering would somewhat narrow the range of eligible products to choose from. However, a large number of suppliers is not always necessary to have effective competition. Further, filtering could generate competition to the extent that funds compete to be included on the preferred default list of default products by performing well against the selection criteria, and compete to be the default fund for large employers (including through competitive processes such as corporate tenders). In that sense, there is more likely to be competition on aspects that are valuable to members, like net returns and fees, though there is still some scope for unhealthy or wasteful marketing to both employers and employees.

The application of administrative filters would be likely to lead to some degree of industry consolidation which, given the importance of scale (Deloitte 2010) in terms of lowering costs and achieving higher returns, should lead to better outcomes for members. This would be less than in some other models but likely to be greater than the baseline.

## Integrity

As noted by Kinetic Superannuation (sub. 45, p. 2), a market-based model must be transparent and credible to ensure that default fund trustees remain accountable for the outcomes delivered to members. The same principles apply to a model with employer choice.

The model with employer choice introduces additional principal—agent issues relative to the unassisted active employee choice baseline. Principal—agent problems may in theory arise between the employer and employee, the organisation responsible for applying the filters and the employee and, potentially, other parties (such as industrial parties) and the employee.

As such, this model — particularly given the implausibility of imposing a regulatory obligation upon employers to act in their employees' best interests — might in principle raise more integrity issues than the baseline. However, in practice, much of the substantive risk lies in the appointment process for the default preferred list panel and the transparency and accountability of the decision-making process.

Implementation of effective appointment processes and governance rules relating to the body made responsible for administering the filters is essential. This model could then achieve higher integrity than that likely to be observed under the baseline.

## **Stability**

The stability impacts of the assisted employer choice (with employee protections) model would be minimal. If a product was removed from the preferred default list, it would still be able to receive default contributions and existing members would be able to remain in it. If a product was removed from the mandatory minimum standards list, the Commission considers it should be ineligible to receive default contributions. To minimise disruption, the Commission considers APRA should oversee a process that would ensure existing members in the now-ineligible default product were shifted to a different product (unless they actively decided to stay in the original product as choice members). The Commission considers this outcome necessary because of the nature of the minimum standards filter: the implication of not meeting the filter is that a product is no longer suitable for default members. Such a scenario would be expected to be very infrequent and only a small proportion of employers or members would be likely affected at any one time.

# System-wide costs

Under the assisted employer choice (with employee protections) model, search costs would be low for defaulting employees (as their choice would effectively be made for them by their employer), and lower than under the unassisted active choice baseline (chapter 4).

Total costs to employers would be somewhat higher than under the baseline. These could be quite high for a few employers, especially if they chose to use tender processes or relatively expensive ways of determining the most suitable products for their employees. However, compared with the more diverse range of products available to employees under the baseline, employers would choose from a far reduced number of potential preferred default products. Further, given there are relatively few employers compared with the number of employees, it is likely that, all else equal, the overall search costs associated with default selection would be lower than under the baseline.

The total cost to funds will be higher under the administrative filter model compared with the baseline, as they would incur the costs associated with participation in the filtering process and, assuming the filtering process was sufficiently competitive, they might also choose to market heavily to employers to gain members. Most of the costs incurred would relate to ongoing compliance with the minimum standards filter. However, the total operating costs for funds would also potentially rise under the baseline, as they competed for members.

The costs to government would be higher than the baseline because government would incur the costs associated with the administrative filters. There would also be the costs

related to the centralised information service (chapter 3). Against this, if the filters succeeded in encouraging better product choices, this could reduce future Age Pension liabilities. This would potentially reduce the inefficiency (sometimes called the 'deadweight loss') associated with raising revenue to fund these liabilities (which is an additional benefit to that of the higher returns obtained directly by those members in more suitable products following the application of the filters).

Table 8.3	Assisted employer choice (with employee protections) model: assessment summary against the baseline
Criterion	Assessment
Member benefits	Presence of administrative filtering should result in more employees in better performing products.
	Use of selection criteria relating to long-term net returns, fees and governance should provide incentives to improve performance.
	Greater involvement of employers could enable better tailoring of products to workplaces in some cases.
Competition	Narrows range of eligible products which could potentially reduce competition.  However, can also generate ready comparability and competition as funds compete to have their products included on the preferred default list, and to be the default fund for large employers. Disclosure and improved comparability could promote active member engagement.
	Will focus competition on aspects of value to members, like long-term net returns and fees, though there is still some scope for unhealthy and wasteful marketing to employers.
	Could provoke some market consolidation, which could benefit members by leading to more efficient providers and better member returns.
Integrity	The role of employers and the panel determining the preferred default list introduces principal—agent issues, meaning this model can be seen as raising more integrity issues. In practice, the main integrity issue would relate to the process for appointing the panel determining preferred default eligibility. This requires effective appointment processes and governance and accountability arrangements.
Stability	Unlikely to create instability, as the model would not lead to excessive market concentration, sudden movement of balances or a short-term focus by trustees.
System-wide costs	Search costs lower for defaulting employees as they effectively have their choice of product decision made for them.
	Total costs to employers increased, particularly if they use relatively expensive ways of choosing a product (such as via tender). However, their ongoing costs might be reduced if they subsequently dealt with fewer providers.
	Overall search costs likely to be lower than under employee choice as there are fewer employers relative to the total number of employees.
	Cost to funds higher as they incur the cost of participating in the filtering process and would be likely to incur costs from marketing their products to employers (although these latter costs may be lower than under the baseline).
	Total costs to government may be higher as they incur the implementation and administration costs of the administrative filter (although if the filter leads to higher balances, this is likely to reduce future Age Pension liabilities).

#### Overall evaluation

The Commission concludes that assisted employer choice (with employee protections) is a workable model which is likely to provide superior outcomes compared with the unassisted active choice baseline.

Most of the benefits associated with the model stem from use of the filters to guide employees to better products, rather than through the choice of product being placed with the employer. Some employers will be well placed to choose products, through corporate tenders or because they have particular expertise, but others may lack the expertise or willingness to incur expense but will still receive some assistance from the filtering. Potential benefits directly relating to employer choice (as distinct from those related to the filtering) would include the opportunity for tailoring of products to workplaces.

#### **DRAFT FINDING 8.1**

Relative to the baseline, assisted employer choice (with employee protections) — employing both a light filter for mandatory minimum standards and a heavy filter for a preferred default list — would:

- enhance member benefits by increasing the likelihood of employees being placed in higher quality products, and reducing the likelihood of them being in a poor product
- promote healthy competition by presenting product providers with incentives to perform strongly against the preferred list selection criteria or compete for corporate tenders and facilitating greater comparability, but there would still be some scope for unhealthy and wasteful marketing to employers
- increase the potential for agency problems given the involvement of employers, although the risk to the *integrity* of the system would lie primarily in the appointment process for the preferred default list selection panel
- create few stability concerns
- reduce search *costs* for employees, while increasing search costs for employers and regulatory costs for funds and government.

#### **INFORMATION REQUEST 8.1**

What are the main drivers of costs to employers in selecting default products on behalf of their employees? Would a shortlist of 'no frills' default products make this task easier for employers? Is there an ideal minimum number of products that should be nominated on the preferred default list?

Are there other specific criteria in addition to those proposed under the minimum standards criteria that default products should meet to protect members and help to achieve better outcomes for them in the long term?

Would a dual-list approach, allowing employers to select a product from one of two lists, provide them with sufficient flexibility to select tailored default products that best meet the needs of their employees?

Which types of employers prefer to retain a role in default product selection? To what extent are default products or corporate fund offerings considered important benefits offered to prospective employees in competitive labour markets?

# Public consultation

In keeping with its standard practice, the Commission has actively encouraged public participation in this inquiry.

- Following receipt of the terms of reference on 17 February 2016, an advertisement was placed in a national newspaper and a circular was sent to identified interested parties.
- An issues paper was released on 20 September 2016 to assist those wishing to make a written submission. A total of 52 submissions were subsequently received (table A.1). Public submissions are available on the Commission's website: www.pc.gov.au.
- As detailed in table A.2, consultations were held with government departments and agencies, academics and superannuation industry participants.

The Commission thanks all parties who have contributed to this inquiry and now seeks additional input for its final report. The Commission welcomes further submissions to discuss the substance of the draft report, including responses to the information requests and draft findings and recommendations.

Table A.1 Public submissions				
Individual or organisation Submission number				
Accommodation Association of Australia (AAA) 16				
Ai Group	21			
AMP	42			
Association of Superannuation Funds of Australia (ASFA)	24			
Australian Chamber of Commerce and Industry (ACCI)	27			
Australian Council of Trade Unions (ACTU)	34			
Australian Hotels Association (AHA)	6			
Australian Institute of Superannuation Trustees (AIST)	28			
Australian Prudential Regulation Authority (APRA)	33			
Australian Securities and Investments Commission (ASIC)	41			
AustralianSuper	19			
Centre for International Finance and Regulation (CIFR)	7			
Centre for Market Design (CMD)	18			
CHOICE	31			
Australian Securities and Investments Commission (ASIC)  AustralianSuper Centre for International Finance and Regulation (CIFR) Centre for Market Design (CMD) CHOICE Club Plus Super 3 Colonial First State 2 Community Clubs Victoria (CCV) Corporate Super Association (CSA) Fair Work Commission (FWC) Financial Planning Association of Australia (FPA) First State Super 1 Cinancial Services Council (FSC) Cinancial Services Council				
Community Clubs Victoria (CCV)				
Corporate Super Association (CSA)				
Fair Work Commission (FWC)				
	29			
Financial Services Council (FSC)	38, 49			
First State Super				
Independent Fund Administrators and Advisers (IFAA), QIEC Super and Club Super	13			
Industry Super Australia (ISA)	40			
Institute of Public Affairs (IPA)	17			
Kinetic Superannuation				
Land, Richard				
Linacre, Andrew	52			
LUCRF Super	30			
Mair, Peter	1			
Mercer	15			
Mine Wealth + Wellbeing	46			
NESS Super	47			
Police Federation of Australia (PFA)	14			
PricewaterhouseCoopers (PwC)	12			
Restaurant and Catering Australia (RCA)	10			
Retail Employees Superannuation Trust (REST)	23			
Rice Warner	43			
Sweeney, Phillip	2, 3, 5, 8			
UniSuper	20			
Vision Super	4			
Workplace Super Specialists Australia (WSSA)				

## Table A.2 Meetings and teleconferences

Individual or organisation

#### **AUSTRALIA**

Ai Group

AMP

Association of Superannuation Funds of Australia (ASFA)

Australian Chamber of Commerce and Industry (ACCI)

Australian Communications and Media Authority (ACMA)

Australian Council of Trade Unions (ACTU)

Australian Institute of Superannuation Trustees (AIST)

Australian Prudential Regulation Authority (APRA)

Australian Securities and Investments Commission (ASIC)

Australian Taxation Office (ATO)

AustralianSuper

Chant West

ClearView

Professor Gordon Clark (University of Oxford)

Department of Employment

Department of Finance

Department of Prime Minister and Cabinet (DPMC)

Fair Work Commission (FWC)

Financial Services Council (FSC)

First State Super and StatePlus

Grattan Institute

Industry Super Australia (ISA)

Mercer

Northern Territory Department of Treasury and Finance

Rice Warner

Treasury

UniSuper

Pauline Vamos

#### CHILE

Professor David Bravo (Pontificia Universidad Católica de Chile)

Superintendent of Pensions

Assistant Professor Felix Villatoro (Universidad Adolfo Ibáñez)

#### **NEW ZEALAND**

ANZ

**Booster Investment Management** 

Commission for Financial Capability

Financial Markets Authority

Financial Services Council

Inland Revenue Department

Kiwibank

(continued next page)

#### Table A.2 (continued)

Individual or organisation

Ministry of Business, Innovation and Employment

New Zealand Treasury

Retirement Policy and Research Centre (Auckland University)

Simplicity

#### **UNITED KINGDOM**

Professor Nicholas Barr (London School of Economics)

# B Select default models overseas

Australia is not alone in grappling with the challenge of allocating retirement savers that do not make an active choice into default products. While Australia's unique superannuation system limits the insight that can be gained from other retirement income systems, there is nonetheless value in considering how other countries deal with the allocation of default members. This is reflected in the Commission's terms of reference, which require the Commission to consider the strengths and weaknesses of competitive processes used internationally.

This appendix provides background on retirement income systems and default arrangements in Chile, New Zealand, the United Kingdom and Sweden. These countries were identified by the Commission in its preliminary research as those most likely to provide useful insights for informing the inquiry. They also share some similarities with the Australian system, including the use of defined contribution schemes in which employees or employers can choose between funds to allocate their contributions.

The sections that follow provide context on each country's overall retirement income system, the mechanisms for allocating savers to default products, and any relevant retirement and default allocation system outcomes.

## B.1 Chile

The Chilean retirement income system was restructured in 1981 based around three pillars: a publicly-financed poverty prevention (or solidarity) pillar, a mandatory contribution pillar and a voluntary savings pillar. For the mandatory contribution pillar — which is the focus of this appendix — the previous 'pay-as-you-go' scheme in which active employees financed the benefits of those who had retired was replaced by an individual accumulation scheme.

In 2006, a study revealed that a significant portion of the population lacked sufficient funds to support themselves during old age, primarily due to a low contribution rate. This was largely explained by labour market informality and periods of self-employment (given self-employed people did not have to make contributions at this time). In the case of Chilean women, there were typically long periods of time during which they did not contribute (Superintendence of Pensions 2010).

The system was therefore significantly reformed in 2008 to increase participation and reduce administration fees in the mandatory contribution pillar and to bolster the solidarity pillar (Shelton 2012).

## The mandatory contribution pillar

The core of the mandatory pillar is a mandatory contribution rate of 10 per cent (subject to a ceiling) on monthly earnings. Employers must deduct an employee's contribution from their pay and forward it to the employee's chosen pension fund (Administradoras de Fondos de Pensiones, or AFP). Employees may choose any AFP and switch at any time, except for new employees (for whom arrangements are discussed below) (Shelton 2012, pp. 2-3).

In addition to the 10 per cent mandatory contribution, employers deduct additional contributions to cover administration fees and insurance premiums (death and disability), which each represent about 1.4 per cent of earnings (Chant West 2016, p. 2). Employees therefore need to contribute at least 12.8 per cent of their earnings towards their mandatory pension.

AFPs must purchase death and disability insurance for their members from a life insurance company through a public tender process (Superintendence of Pensions 2010, p. 95).

#### The nature of AFPs

AFPs are single-purpose institutions that charge fees as a percentage of an employee's salary. They must collect pension contributions, take action in case of payments being in arrears, invest resources, manage pension processes and, in some cases, disburse pensions. They are also generally responsible for all processes that are requested by members involving their own funds (Superintendence of Pensions 2010, pp. 17–18).

AFPs are subject to meeting minimum investment performance provisions which require each of their investment returns for the previous 36 months to be comparable with other AFPs. Otherwise, the difference in performance must be made up through transfers from a cash reserve equivalent to 1 per cent of each AFP's value or, should this be inadequate, by a government guarantee to make up the difference that, if required, would trigger the liquidation of the AFP (Superintendence of Pensions 2010, p. 60). This means AFPs typically invest in a very similar manner to ensure they are not caught out by these provisions (Vásquez 2004).

Election of the boards of directors of AFPs is regulated. AFP boards must include at least five directors, two of whom must be independent. An independent director shall be defined as one having no ties with the AFP, the other companies in the business group it belongs to, its controller, or with the main executives of any of these, any of which could

potentially generate a conflict of interest or otherwise threaten the director's independent judgment (Superintendence of Pensions 2010, p. 58).

If an AFP is dissolved for any reason, the Superintendence of Pensions is responsible for liquidating the company and managing its pension funds. The liquidation of an AFP only affects the company and not the pension funds it manages. The individual accounts are transferred to a new AFP chosen by each member (Superintendence of Pensions 2010, p. 98).

#### Fees

AFPs are free to set their own administration fees, but must charge the same fee (that is, the same percentage of salary/contributions) for all members. Only contributors pay this fee, and these represent about half of all members (Chant West 2016, p. 2).

There are limits on the investment fees AFPs can pay to external fund managers (which vary according to the asset class, and whether management is passive or active), and the fees paid must be disclosed to regulators on a monthly basis. The Superintendence of Pensions subsequently publishes these data on its website (although not broken down by types of investment or asset classes) (Chant West 2016, p. 10).

Employee contributions are tax deferred in that contributions and earnings are tax exempt until withdrawal. Retirees pay regular income tax on their pension income (Chant West 2016, p. 2).

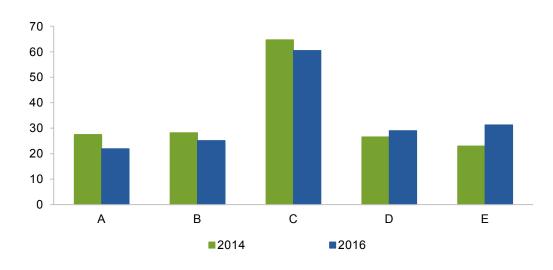
#### **Fund options**

Since 2002, AFPs have been able to offer up to five investment funds, named A to E, with differing proportions of investment in equities. The assumption is that more equities equals greater risk. All funds must offer funds B to E while fund A (the riskiest) is voluntary. In practice, all AFPs offer all five funds. Members may invest in two of them, although older members are restricted from investing in the riskiest funds (Superintendence of Pensions 2010, pp. 34–35). All funds are heavily regulated regarding the proportion of various investments they are allowed to make. To simplify the system, fee structures are uniform across investment options (Superintendence of Pensions 2010, p. 38).

Where members do not make a choice of fund, they are, by law, allocated by their AFP to funds based on their age (table B.1). The shift from one fund to another is also gradual, with 20 per cent of assets shifted at the time of the change, and a further 20 per cent transferred each year until the transfer is complete (Superintendence of Pensions 2010, p. 35). Fund C had the largest share of total assets under management in 2016 (figure B.1).

Table B.1 Default assignment by age where no investment fund option chosen, Chile Men and women up to Men aged between 36 Men 56 and over age 35 and 55 Women 51 and over Women aged between Pensioners 36 and 50 Fund A - Most Risky Fund B - Risky Fund C - Intermediate Fund D - Conservative Fund E - Most Conservative Source: Superintendence of Pensions (2010, p. 35).

Figure B.1 Assets under management by investment option (\$USbil), Chile



Data sources: Chant West (2014b, p. 5, 2016, p. 4).

# The tender process for new employees

#### Rationale for tender

The 2008 reforms included the introduction of a tender system, enabling AFPs to bid for new entrants to the workforce for a two-year period. The process was designed to increase competition between AFPs and therefore reduce fees. Prior to the introduction of the tender system, all new employees had to choose an AFP, leading to concern about high costs associated with marketing by AFPs. In particular, concern focused on the use of large

commission-driven sales forces to encourage people into funds (driving up administration costs), and about arguably questionable incentives such as electrical appliances being offered to members.

The tender also sought to reduce barriers to entry for new AFPs who could now, if successful in the tender, be guaranteed new customers without incurring high marketing costs (Shelton 2012, p. 8). All new entrants to the workforce, including the self-employed, are required to join the AFP successful in the tender.

The focus on new employees is based on the relatively large influence of fees on employees with low balances. It is assumed fees are more important than investment performance to people newly entering the system. When initially implementing the tender, it was also considered the pool of new workers over two years would be of sufficient size to meet the minimum efficient scale requirements for a new AFP (Superintendence of Pensions 2010, p. 166).

#### The tender process

Under the tender process, the AFP with the lowest administration fee (which must be less than the fee in effect at the time of the bidding process) becomes the new default provider. New entrants to the workforce are obliged to join that AFP and stay with it for two years (except under certain circumstances, such as the fees not being the lowest available, or not being satisfactory to make up for a higher yield from another AFP). The successful default AFP must maintain fees at the same level for the two years of the tender period, beyond which it is assumed competition between AFPs will ensure fees remain competitive (Superintendence of Pensions 2010, pp. 166–167). Details of losing tender bids are published, including the name of the tenderer and the fee level tendered.

The AFP successful in the tender must offer the same price to all members (old and new). The fee must be a fixed percentage of salary (that is, contributions not balances). It covers administration costs, distribution costs and the cost of the internal investment team. It excludes the investment fees charged by external fund managers, which amount to about 0.25 per cent per year as a proportion of total assets (Chant West 2016, p. 1).

#### Tender outcomes

The first tender in 2010 was won by a new AFP, Modelo, with a bid of 1.14 per cent of salary. It subsequently won the second tender with a bid of 0.77 per cent. PlanVital won the third tender in 2014 with a bid of 0.47 per cent. PlanVital also won the fourth tender in 2016 with a bid of 0.41 per cent. PlanVital was the only participant in this tender, and was successful as it met the requirement to reduce its fee below the level determined in the previous tender (Superintendence of Pensions 2016b).

When PlanVital won the third tender, its administration fee was reduced from 2.36 per cent of salary to 0.47 per cent. Chant West has questioned the long-term sustainability of this fee, noting that profits have been very low for PlanVital (Chant West 2016, p. 9). That said. PlanVital was able to reduce its fee in the most recent tender.

The aim of increasing competition between AFPs was partially achieved initially when a new AFP won the first tender. However the number of AFPs has only increased from five, before the tender was introduced, to six. The number of AFPs was 12 in 1981, before increasing to 21 by 1994, and subsequently declining to 5 by 2008 due to mergers and closures (Shelton 2012, p. 8).

The two AFPs to have successfully won the tender, Modelo and PlanVital, are much smaller than the other four AFPs (roughly one-tenth of the size of the largest, based on assets under management). This suggests established funds with pre-existing large pools of relatively high-margin clients do not find the default tender attractive, and prefer to operate solely in the choice sector.

PlanVital, the most recent winning tenderer, has had inferior investment performance relative to other AFPs over the past three years (Superintendence of Pensions 2016a). However, this is not to say that new default members are worse off with PlanVital (particularly as this group would typically have low balances, increasing the relative importance of fees to them). They may achieve higher net returns with PlanVital after all fees (including administration fees) are accounted for, at least in the short to medium term.

#### **B.2 New Zealand**

KiwiSaver — an automatic-enrolment, voluntary retirement savings scheme — was introduced in July 2007 with the objectives of encouraging saving and increasing living standards in retirement. The introduction of KiwiSaver followed concerns about saving rates and particularly about the potential for middle class New Zealanders to have large reductions in their living standards post-retirement. Cabinet papers acknowledged the potential for this to merely subsidise existing saving (St John, Littlewood and Dale 2014, p. 10).

KiwiSaver — which sits alongside New Zealand's universal old-age pension scheme (known as New Zealand Superannuation) — was set up as an automatic-enrolment scheme for new employees, with employees given eight weeks to opt out. Anyone not opting out in these eight weeks is required to stay in the scheme for at least 12 months.

There have been a number of revisions to KiwiSaver since its introduction, particularly due to concerns about the cost of the scheme and doubts about its impact on national savings rates (box B.1).

# Box B.1 KiwiSaver has been subject to a number of changes since its introduction

Initial arrangements for KiwiSaver included a \$NZ1000 kick start payment from the New Zealand Government and a subsidy of \$NZ40 to cover membership fees. Workers initially contributed either 4 or 8 per cent of their gross income. Matching contributions from employers were tax-exempt. KiwiSaver also included a first home-owner deposit subsidy that remains a feature of KiwiSaver.

KiwiSaver II was announced in May 2007, *before* the initial scheme had begun, with government matching contributions of about \$NZ1040 a year, and partly offsetting employer tax credits for employer contributions. Compulsory matching employer contributions were introduced, starting at 1 per cent from 1 April 2008, and then rising by a further 1 per cent each year to a peak of 4 per cent from 1 April 2011.

KiwiSaver III was announced in 2008. Effective from April 2009, the \$NZ40 fee subsidy was dropped and minimum employee contributions were lowered from 4 to 2 per cent. Employer contributions were capped at 2 per cent and the employer tax credit removed.

KiwiSaver IV was announced in 2011. From 1 July 2012, employer contributions became subject to tax (the 'employer superannuation contributions tax'). The maximum tax credit was halved to \$NZ521.43 (while the contribution required to qualify stayed the same). The minimum employee and employer contributions increased from 2 to 3 per cent from 1 April 2013.

The \$NZ1000 kick start payment was discontinued from 21 May 2015.

The Commission for Financial Capability recently recommended that minimum employee and employer contributions increase to 4 per cent by 2021.

Sources: CFFC (2016); Littlewood (2012); St John, Littlewood and Dale (2014, pp. 10-12).

# KiwiSaver as it currently operates

Employees can choose to contribute either 3, 4 or 8 per cent of their gross pay. Self-employed or unemployed people can tell their provider how much they wish to contribute and make payments directly to the provider (Inland Revenue 2016b). KiwiSaver savings are normally locked in until a member turns 65 or, if they joined after 60, five years after joining.<sup>32</sup> Although changes to future old-age pension eligibility have been announced recently by the NZ Government, these will not affect arrangements for KiwiSaver (Joyce 2017).

Contributions are deducted from the member's pay and sent by the employer to Inland Revenue for distribution to the chosen provider. Inland Revenue's role as a clearing house for contributions is widely considered to be an important feature of KiwiSaver (box B.2).

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<sup>32</sup> Early withdrawals are possible in some circumstances, like buying a first home, significant financial hardship or a serious illness (Inland Revenue 2014).

#### Box B.2 Inland Revenue's role as a clearing house

Inland Revenue uses New Zealand's pre-existing PAYE income tax system for its clearing house role. Employers deduct employee contributions, make compulsory employer contributions and remit these directly to Inland Revenue. Inland Revenue transfers KiwiSaver contributions to each employee's relevant KiwiSaver scheme provider (Inland Revenue 2017).

The clearing house is widely considered to be an important and successful part of KiwiSaver. The Commission consulted with KiwiSaver funds, New Zealand government organisations and academics, most of whom highlighted what they consider to be the clearing house's benefits:

- ensuring each individual has only one KiwiSaver account
- low administration costs for employers and funds
- the ease with which Inland Revenue can monitor employers' compliance with mandatory contributions
- its simplicity for funds facilitates market entry and competition between providers.

One drawback noted by some parties is that Inland Revenue does not have up-to-date contact details for all employees, making it harder for providers to communicate with their members. (However, this issue would likely still exist under a different system.)

Employers must make compulsory contributions equivalent to 3 per cent of gross pay (regardless of the contribution rate of the employee). They can voluntarily make further contributions above this level. Employers need not make contributions to KiwiSaver if they are contributing to another eligible superannuation scheme, if the staff member is under 18 or over 65 (or if they joined aged over 60 and have been a member for 5 years) or if the staff member is not contributing (for example if they are opted out on a contributions holiday or leave without pay) (Inland Revenue 2016d).

Auto-enrolled members are allocated to a default KiwiSaver product by Inland Revenue on a sequential basis. Their initial allocation is considered provisional and confirmed as final where the member fails to make a specific choice. If an auto-enrolled member chooses a provider within three months of being enrolled, their contributions will go to that provider rather than the provider they were provisionally allocated to.

Members can change scheme providers anytime by applying directly to the provider of the scheme they want to join. The new provider will then arrange for their savings to be transferred from the old scheme to the new one and notify the member. A member can only be in one scheme at any given time (Inland Revenue 2016a). If a KiwiSaver provider closes down, members may transfer to a new scheme or, if they do not do this, they will be allocated by Inland Revenue to a default scheme.

Anyone who has been a member of KiwiSaver for 12 months or more can take a contributions holiday of between three months and five years. There is no limit to the number of times a contributions holiday can be taken.

As at 31 March 2016 there were 2.6 million KiwiSaver members, with about \$NZ33.8 billion in scheme assets (FMA 2016, p. 13). KiwiSaver providers are regulated by the Financial Markets Authority (Inland Revenue 2016c). At 31 March 2016 there were 24 retail funds and 8 restricted funds. Ten schemes represented nearly 87 per cent of members (FMA 2016, p. 5).

#### Investment strategy

Default members must be allocated to a conservative investment option. Investment exposure to property and shares is low. Between 15 and 25 per cent of the portfolio must be in growth assets. Given the need to stay within these parameters, a 'safety margin' is generally maintained. Ministerial approval is required for any moves outside these limits.

The default fund in KiwiSaver has been described as a 'transitional parking space where members resided temporarily before they made an active choice' (MBIE 2012, p. 6). A significant proportion of members do move away from their default fund. For example, about 34 per cent of members who were initially in a default fund in 2008 had transferred to a new provider by 2012 and another 5 per cent had switched investment options within the same default provider (MBIE 2012, p. 34).

However, about 56 per cent were still with their initial default provider in 2012 (MBIE 2012, p. 36).

Staying in a conservative investment product could be very costly to members in the long term. MacDonald, Bianchi and Drew (2014, p. 31) noted that the conservative approach to default investing meant 'KiwiSaver members are inadvertently exposing themselves to the hidden risk of failing to reach a retirement target that will enable them to enjoy standards of living in retirement similar to those in pre-retirement'. They also found that increased investment in equities would enable KiwiSaver defaulters to increase the upside potential of their investments without significantly increasing risk.

#### Fees

Non-default KiwiSaver providers are relatively free to set their own fees, with the KiwiSaver Act stating that fees relating to KiwiSaver must not be 'unreasonable'.

As is generally the case with pension plans involving multiple providers, making fee comparisons under KiwiSaver is difficult. For the 21 KiwiSaver providers for which published investment performance data were available in 2014, there were more than 165 investment options, ranging from investment solely in cash, to solely in shares. Fees would be expected to vary widely across these options (St John, Littlewood and Dale 2014, p. 18).

A 2015 NZ Treasury paper found that KiwiSaver's operating costs were about the median for global pension systems, noting that countries with defined contribution schemes and

large numbers of funds are likely to have higher costs than countries with few funds. The paper also noted that KiwiSaver fees tend to be lower than superannuation fees in Australia (Heuser et al. 2015, pp. 45-47). The Grattan Institute has also noted this (Minifie, Cameron and Savage 2014, pp. 25–26). However, in looking at these comparisons, it is relevant that many KiwiSaver schemes employ low cost investment strategies. The Grattan Institute noted 'the [NZ] default asset allocation has been criticised for over-emphasising low-risk assets and giving growth assets too little weight' (Minifie, Cameron and Savage 2014, p. 25).

# The KiwiSaver default tender process

To determine eligible default KiwiSaver providers, the NZ Government commenced a tender process in 2006. The government appointed an expert panel to review the submissions received and create a shortlist for interview. The panel then made recommendations to the minister.

A number of factors were included in the selection criteria, including:

- security and organisational credibility
- organisational capability
- the proposed design of the provider's default KiwiSaver scheme
- administrative capability
- competitive fee levels
- investment capacity and capability (Cullen and Dalziel 2006).

It is widely believed that the expert panel recommended appointing either four providers or all of those satisfying the minimum criteria, although six funds were ultimately appointed (Littlewood 2012, p. 11). It has been suggested that this followed direct approaches to the NZ Government from tender participants not initially listed in the preferred four. This highlights the possibility (and risk) of ministerial intervention in tender processes, and particularly multi-criteria tenders where the weighting given to the various considerations (and therefore the basis for the final decision) might be unclear. This risk needs to be a major consideration when designing a tender model.

The six funds appointed in the 2006 tender process were:

- AMP Services (NZ) Limited
- ASB Group Investments Limited
- ING (NZ) Limited
- Mercer Human Resource Consulting Limited
- National Mutual Corporate Superannuation Services Limited (trading as AXA New Zealand)
- Tower Employee Benefits Limited (Cullen and Dalziel 2006).

A number of criticisms have been made of the 2006 tender process. For example, Littlewood (2012, pp. 11–12) suggested the process:

- was not transparent, with reasons for government decisions not being adequately disclosed
- resulted in decisions being made on a 'least risk to government basis', rather than being based on the best interests of members
- resulted in too many default providers being appointed given the size of the market.

Concern has also been expressed about the competitive advantage attained by funds provided KiwiSaver default status (Littlewood 2012, pp. 10–11). This advantage is even greater if people assume the government has done 'due diligence' on the funds, or if they erroneously believe they are government guaranteed. Cabinet papers prepared ahead of the 2014 tender process noted that, at that time, about 37 per cent of KiwiSaver members had entered through default arrangements, and 23 per cent of KiwiSaver members remained as default members (having never changed their provider or investment option) (NZCO 2013, p. 1).

The first tender covered the period 2007 to 2014.

A similar process was carried out for the second tender, covering a seven-year period from 1 July 2014. A panel of evaluators with relevant industry expertise evaluated proposals according to 'technical' criteria (assigned a 70 per cent weighting) such as organisational capability, member education and investment capability; and the providers' pricing levels (assigned a 30 per cent weighting) (MBIE 2013, p. 3).

Cabinet documents relating to the second tender concluded that the initial selection criteria had served default members well in ensuring well-governed and competitively priced funds. The major item of consideration between the first and second tender related to the appropriateness of the investment strategy, with consideration being given to shifting from a conservative to a balanced or life-cycle approach.

It was determined that KiwiSaver default funds should continue to be designed as 'parking spaces' before people shifted to more suitable funds rather than being intended as the most appropriate long-term investment vehicle for individuals. As such, it was determined the conservative approach to investment should continue (NZCO 2013, p. 7).

In view of the importance of educating people to shift from the default fund, one change was made to the selection criteria between the first and second tender processes. This was the introduction of a requirement that prospective default providers demonstrate how they will offer investor education to encourage default members to make more active choices about investment options (box B.3). Otherwise, the selection criteria employed were the same as those for the initial tender (English and Foss 2013).

#### Box B.3 The push for financial literacy

In keeping with the priority of ensuring KiwiSaver members choose the most suitable products for their needs, the Financial Markets Authority has a three year plan to increase financial literacy. Default providers must address the financial literacy of their default members. They must report on their commitments to encourage members to choose an investment within their scheme, and the number of members who do this.

The Financial Markets Authority highlighted the approach of Grosvenor (now known as Booster) to contacting default members, as this is seen as the most successful approach (with a 22 per cent success rate). The approach consists of:

- · data clearing and checking to ensure all staff can call members
- three follow up calls if the first call is unsuccessful
- · ascertaining the extent of the member's knowledge
- tailoring conversations
- · taking members through questions about their risk profile, and switching them to another option while they are still on the phone.

Source: FMA (2016, p. 12).

The cabinet papers also show that consideration was given to the treatment of default providers and their members (from the first tender) who were unsuccessful in the second tender. It was considered that default members should continue to benefit from the protections provided by the instruments of appointment that followed the tender, meaning they should be transferred to a new default fund. However, as some members might wish to choose to stay in the original fund, members to be transferred should be given an opt-in election form providing them with this opportunity (NZCO 2013, p. 14).

Consideration was also given to the seven-year appointment process, which was seen as providing a reasonable period of incumbency, while not allowing for complacency on the part of providers (NZCO 2013, p. 15).

The 2014 KiwiSaver tender process broadly involved two steps: a shortlisting of suitable KiwiSaver default funds, followed by a fee negotiation stage designed to place downward pressure on KiwiSaver default fees. The Commission understands this stage led to fee reductions from some providers.

Following that tender process, there are currently nine default providers. Although there have been name changes, mergers and acquisitions, none of the initial default providers lost their default status. The current providers are:

- AMP Services (NZ) Limited
- ANZ New Zealand Investments Limited
- ASB Group Investments Limited
- Booster Investment Management Limited

- BNZ Investment Services Limited
- Fisher Funds Management Limited
- Kiwi Wealth Limited
- Mercer (NZ) Limited
- Westpac New Zealand Limited (Inland Revenue 2016a).

In the year ending 31 March 2016, the share of members contained in the nine default funds fell from 18 to 17 per cent, while the share of total assets in default funds fell from 14.3 to 12.5 per cent (FMA 2016, p. 13).

#### 2014 evaluation of KiwiSaver

Inland Revenue (in conjunction with other government organisations) undertook an evaluation of KiwiSaver in 2014, based on the seven-year period between 2007 and 2014. It was noted that this was a relatively short time in which to evaluate a program designed to have a long-term impact, and that the impact of the Global Financial Crisis was likely to have influenced program outcomes.

Key findings of the evaluation included that:

- both employees and employers had been broadly supportive of KiwiSaver, and employers did not consider it to be particularly burdensome
- KiwiSaver knowledge is associated with income and asset accumulation of assets. The more assets individuals have, the higher their likely knowledge about KiwiSaver
- KiwiSaver contributions appear to be increasingly made at the expense of paying off mortgage or other debt (Inland Revenue 2015).

# **B.3** United Kingdom

In 2008 the UK Government, concerned about inadequate retirement incomes, introduced major reforms to its retirement system. The centrepiece of the reforms was a requirement for employers to automatically enrol their workers in an occupational pension scheme, with workers able to subsequently opt out of the system. The new system is still being phased in, and is expected to be fully in place in 2018. While this limits the scope to draw lessons from the reforms, there is nonetheless value in considering the system's policy design and early outcomes.

# The UK retirement system

The United Kingdom's retirement system has three parts: a means-tested state pension, individual retirement savings plans, and occupational pension schemes.

The focus of the UK Government's 2008 reforms was on the occupational pension system. Employers must automatically enrol workers aged over 22 and earning more than £10 000 into an occupational scheme. 33 Employers must contribute an amount equivalent to at least 3 per cent of a worker's after-tax earnings into the scheme, with workers contributing 4 per cent and the Government another 1 per cent. Contributions are largely exempt from tax.

Employers choose which pension scheme (or schemes) they use to enrol their workers into. When workers change jobs they can consolidate their pension accounts into their new employer's pension scheme. Employers are not required to make contributions into pension schemes that they do not use to meet their enrolment obligations.

Most occupational pension schemes are provided by large insurance companies, and include a mix of defined contribution and defined benefit schemes (although the share of the latter is declining).<sup>34</sup> The market is relatively concentrated, with four large providers holding the majority of schemes, assets and members (OFT 2013).

# The default pension scheme

When the UK Government introduced its reforms, it was concerned that some small businesses may be unable to secure the services of a private pension provider. To remove this risk the government created a default pension scheme — the National Employment Savings Trust (NEST). NEST has a public service obligation to admit any worker automatically enrolled by their employer, even if the cost of administering the member's account is greater than the revenue derived from member charges (UK DWP 2016).

NEST is a non-departmental public body, operating at arm's length from government with a duty to act in the interests of scheme members. The trustee (NEST Corporation)<sup>35</sup> is the main governing body. NEST and NEST Corporation are regulated by The Pensions Regulator, which is responsible for ensuring that pension schemes are adequately funded, run in the best interests of members, and that employers meet their enrolment and contribution obligations.

To pay for the costs of administering and managing NEST, members pay a 0.3 per cent annual charge on total assets under management. A temporary 1.8 per cent charge on each contribution is also levied to help repay a loan from the UK Government to establish the scheme.

<sup>33</sup> These schemes are not required to provide insurance.

<sup>&</sup>lt;sup>34</sup> In certain circumstances individuals can transfer from defined benefit schemes to defined contribution schemes, the latter of which offer individuals greater flexibility in accessing their savings.

<sup>35</sup> The Secretary of State for Work and Pensions named the initial NEST trustees, along with members of advisory panels representing workers and employers. NEST is now largely self-governing though accountable to parliament through the UK Department for Work and Pensions.

Employers are not required to use NEST to meet their enrolment obligations. However, any scheme used instead must meet a number of regulatory requirements (table B.2). These requirements differ depending on the employee; those already in an occupational pension can be enrolled in a scheme registered as a 'qualifying scheme', while those without an occupational pension must be enrolled in a scheme registered as an 'automatic enrolment' scheme. Competition with the private sector is intended to ensure NEST provides value for money.

Workers can continue contributing to their NEST account if they stop working or change jobs. To help members consolidate their pension accounts, from April 2017 it is intended that all members will be able to transfer pension accounts into or out of NEST (NEST 2015).

#### NEST's investment and administration services

NEST provides a series of retirement date funds to deliver its default investment strategy. At any time there are up to 50 retirement date funds (the 'NEST Retirement Date Funds'). Each fund has an asset allocation consistent with the expected amount of risk that is suitable for that stage in a scheme member's savings career.<sup>36</sup>

NEST's investment strategy is relatively conservative. In contrast to many other retirement date funds, NEST invests the savings of workers in their twenties in low-risk investments. It then invests in higher-risk investments in the middle years, before transitioning back to low-risk investments as retirement age approaches. NEST uses this strategy to reduce the risk that early losses in a person's savings lifetime could discourage them from saving (Sass 2014).

NEST contracts out its investment and administration services to the private sector.

- NEST Corporation delegates much of its investment strategy to an investment committee. The committee assembles a set of funds in house from low-cost funds offered by major investment houses. There are currently 14 fund managers appointed to invest on behalf of NEST members.
- Administration services are provided by Tata Consultancy Services. NEST recently extended Tata's contract to provide administration services until 2023. State Street Corporation is the fund administration partner.

It appears from NEST's procurement ePortal that it uses both tenders and auctions to procure services. Funds and investment managers are selected using a competitive tender process and the advice of independent external investment advisers (NEST 2016, p. 38).

<sup>36</sup> Scheme members may choose one of the following alternatives to the default investment strategy: the Higher Risk Fund, Lower Growth Fund, Ethical Fund, Sharia Fund and Pre-retirement Fund.

Table B.2 Regulatory requirements for UK pension products <sup>a</sup>		
Scheme type	Can be used for	Requirements
Qualifying scheme	Employees already in the scheme (to be registered as a qualifying scheme)	<ul> <li>An occupational or personal pension scheme</li> <li>Tax registered</li> <li>Meets minimum 'quality requirements' for defined contribution schemes         <ul> <li>Employer contributions at least 3 per cent</li> <li>Total contributions at least 8 per cent</li> </ul> </li> <li>Personal pension schemes must be regulated by the Financial Conduct Authority, and have their operations carried out in the United Kingdom by a person authorised or exempt under the Financial Services and Markets Act 2000 (UK)</li> </ul>
Automatic enrolment scheme	Employees not in a scheme	<ul> <li>The requirements above</li> <li>No barriers to enrolment into the scheme (such as age restrictions)</li> <li>No requirement for members to express a choice or provide information to retain membership</li> <li>Main administration in the United Kingdom or another European Economic Area country</li> <li>No consultancy payments to third parties under an agreement with the employer</li> </ul>

a The minimum requirements to certify an occupational pension scheme differ depending on the type of scheme. The table includes some of the main requirements for defined contribution schemes. If employers do not meet the criteria, they can still have their scheme certified if they meet various other requirements that relate to minimum contribution rates.

Sources: The Pensions Act 2008 (UK); TPR (2016).

## Impacts of the 2008 reforms

Since the UK introduced its reforms, the number of people with occupational pension accounts has grown considerably, from about 27 million in 2011, to over 30 million in 2014 (PPI 2016). By May 2016 nearly 6.3 million employees had been automatically enrolled into an occupational pension (UK DWP 2016).

Fewer people are opting out of their pension schemes than the government expected. Overall opt-out rates are about 9 per cent, although rates vary across different groups. Some research suggests that women, older workers and part-time workers are more likely to opt out (PPI 2015).

NEST has a large share of the market. In 2016 it had over 3.2 million members and more than 125 000 participating employers. By contrast, NEST's two major competitors, NOW: Pensions and The People's Pension, had about 0.9 million and 2 million members respectively (Fernyhough 2016). NEST's large market share is likely to be partly due to it

being the only scheme required to accept all employers, regardless of whether it is profitable to do so.

It is claimed that NEST has influenced the automatic enrolment marketplace by driving up standards and best practice (UK DWP 2016). The UK Government is now considering whether to allow individuals to opt into NEST (that is, employees would not have to rely on their employer using NEST to meet their enrolment obligations), and whether to reduce the earnings threshold for automatic enrolment (UK DWP 2016).

# B.4 Sweden

# The Swedish retirement income system

In 1999 Sweden reformed its national retirement income system, replacing its generous universal pension and supplementary earnings-related pension with a new three-tier system.<sup>37</sup>

- The main source of retirement income today is a notional defined contribution scheme, called the *income pension*. The scheme is notional in the sense that contributions are notionally accumulated according to a rule based on earning trends, rather than actual returns. As such it shares some similarities with defined benefit schemes. The income pension is funded by contributions worth about 16 per cent of salary and other taxable benefits. Retirement payments (an annuity) are financed out of current members' contributions, and are based on the life expectancy of the recipient.
- The income pension is supplemented by the *premium pension* (mandatory defined contribution individual accounts). <sup>38</sup> Individuals can select which provider or providers invest their contributions (up to five funds can be chosen), or otherwise be allocated to a default fund. The purpose of the premium pension is to provide individuals with some control over their investments, and the scope to increase returns and diversification (SIFA 2015). The pension is funded by contributions worth about 2.5 per cent of salary and other taxable benefits. At retirement, pension assets are converted into an annuity.
- Poverty relief is provided for low-income individuals through the *guarantee pension*. The guarantee pension is funded out of general taxation, and is unaffected by returns in the premium pension system it only accounts for the income pension.

Administration of the national pension system is centralised within the Swedish Pensions Agency (SPA) (box B.4).

<sup>&</sup>lt;sup>37</sup> The current national retirement system operates alongside occupational pensions (stipulated in some collective agreements, covering over 90 per cent of the workforce), and voluntary private pensions.

<sup>38</sup> There are no requirements to provide insurance.

#### Box B.4 The Swedish Pensions Agency

The Swedish Pensions Agency (SPA) administers the national pension system. It plays the role of a central clearing house, distributing the income pension and premium pension contributions it receives from the National Tax Authority (which collects contributions from employers) to relevant funds. The central clearing house was established to minimise administration costs (Hagen 2013).

The SPA deposits contributions once a year, after complete wage records for a calendar year are available from the tax authorities. The SPA keeps all records of individual accounts, and has one aggregate account for each fund. Funds have no information on individual participants. All individual transactions for a given fund are aggregated at the end of each day and transmitted as a net aggregate to the relevant fund. The SPA also administers benefit payments (annuities).

The SPA is headed by a board appointed by the Swedish Government. It is financed by pension savers through a fee on balances. In the absence of a direct relationship between savers and funds, the SPA aggregates member transactions and negotiates fees for choice products (Minifie, Cameron and Savage 2014).

## The premium pension system

Individuals face a significant amount of choice when selecting a premium pension — there are several government-managed funds and over 850 registered private products operating in the market.<sup>39</sup> To help individuals choose, the SPA provides detailed information on funds, including time series data on returns, risk and fees. It also provides a tool that individuals can use to simulate future returns on the basis of different input variables. The Swedish Investment Fund Association also provides online tools to facilitate fund comparisons and evaluations.

#### The default fund

When the premium pension was launched, the government established a default fund for individuals who did not choose a fund. Workers are only defaulted once when they join the workforce.

Initially, reformers had suggested that the default should be a low-risk fund. However, policy makers were concerned that such a strategy would mean that low-income earners, considered more likely to be in the default fund, would earn lower returns than high-income earners (Hagen 2013). As such, the goal of the current default fund, AP7, is to achieve a rate of return that exceeds the average return of private funds in the premium pension system.

<sup>&</sup>lt;sup>39</sup> Funds must sign a contract with the SPA that specifies reporting requirements and the fee structure. The total fee in the premium pension consists of two parts: a money-management fee and a fixed administrative fee. In 2015, fees in the premium pension system were capped at 0.62 per cent of assets for balanced funds and 0.42 per cent for fixed income funds.

AP7's default investment is a life-cycle product, which automatically adjusts the risk composition of an individual's portfolio with their age. Until an individual turns 55, all contributions are invested in equities (with a mix of active and passive management), to allow for a high rate of return. As retirement draws nearer, the risk level is automatically adjusted downwards by letting the share of assets invested in fixed income securities rise.

AP7's investments are managed either in-house, or by external asset management firms. External managers are contracted to provide either passive management of global equities, pure active management, or private equity fund management.

AP7 also competes in the choice market, offering three other investment portfolios that individuals can choose from. These funds have different mixes of equity and fixed income (an aggressive fund, a balanced fund and a conservative fund). Individuals can also opt to have their entire investment in the equity fund or the fixed income fund.

## Impact on competition

When the premium pension was launched, the Swedish Government encouraged people to choose their own fund. An information campaign suggested that a person's opportunity to affect their pension benefits was surrendered by investing in the default. As a result, more than two-thirds of new savers chose a fund.

Since then the share of new savers that actively choose their own fund has steadily declined, with most now allocated to the default. In 2011 about 98.5 per cent of new savers joined the default, and there is evidence that many do so by making a deliberate passive choice (Barr 2013). That said, about 70 per cent of savers aged between 40–60 eventually move their savings from the default fund (SIFA 2015).

A number of reasons have been offered for the decline in new savers making an active choice. These include an excessive amount of fund choice, the outbreak of the dot-com bubble immediately after the launch of the premium pension, and the strong performance of AP7 compared with other premium pensions (Hagen 2013). AP7's management fees have in the past been less than half that charged by the average premium pension fund (Barr 2013). From 2000 to 2015, AP7 Safa averaged an annual return of 4.91 per cent, compared with 2.57 per cent for choice funds (Better Finance 2016).

In general, premium pensions have achieved higher returns on average than income pensions. Between 1995 and 2014, premium pensions averaged 6.4 per cent annual return on investments, compared with 2.5 per cent for income pensions (SIFA 2015). And while the income pension system has more assets under management, the relative size of the premium pension system has been growing.

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