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An Integrated View of Alternative Default Models and the CIPRs Framework

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Purpose

To develop an integrated view across the PC alternative default models and Treasury's Comprehensive Income Products in Retirement (CIPRs) framework with a view to:

- addressing a major gap that has emerged in relation to contestability of the default retirement benefits market;
- ensuring more effective and streamlined policy consultation, development and implementation processes; and
- marshalling the alternative super default model to support the Government's objectives for super and the development of CIPRs.

Summary and Conclusion

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

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

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

Two approaches for addressing this gap are identified: One option is to address the contestability of the retirement phase in a separate process from the accumulation phase. A second option is to cover both accumulation and retirement phases in a single integrated process.

While both of these options have merit, as discussed below, on balance the single-integrated approach is considered the most effective approach in the long term. Under this approach, the model for injecting contestability would apply to all new default super members through both the accumulation and retirement phases. This would also require modification of the default fund selection criteria to include retirement benefits.

Background

The PC draft report is focussed on creating contestability for new default members entering the superannuation system in the accumulation phase only. More explicitly, the PC states:

*"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." (PC Default Super Model Report p61)*

The report defines member benefits such as to exclude retirement benefits. Specifically:

*"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.**" (PC 2017 p51). (emphasis added)*

In excluding the retirement phase from its analysis, the Commission states that:

“Stage 3 of this inquiry process may allow for the wider issue of failure to develop pension products to be better exposed.”

The purpose of the Treasury discussion paper for CIPRs is to develop a regulatory framework to support members transitioning into retirement by facilitating trustees to preselecting a comprehensive income product in retirement for each member. This will, in effect, create the soft default for retirement. The issue of contestability (ie creating competition **for** the market) of default retirement accounts, is beyond the scope of the review.

This leaves open the question of how competition *for* the default retirement benefit market will be achieved.

This is an important gap as it is widely accepted that good disclosure, while necessary, is only the starting point. Where market imperfection exists, competition **for** the market plays an important role in ensuring efficiency and that members’ best interests are met. Without clarity about this question, current consultation processes will be impeded and policy outcomes could thus potentially be compromised.

Policy Alternatives

According to the Commission, it supports in principle 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. It then limits the scope of the alternative default model to accumulation leaving open the question of what happens when the member reaches the benefit stage.

- Will the default member continue in a default fund in which retirement benefits were not part of the selection criterion (status quo)?
- Will a separate contest for default retirement benefit funds be established (two stage process)?
- Will the alternative default model be extended to the retirement phase (integrated approach)?

To ensure the effectiveness of the current consultation processes, it’s important to clarify when and how the government intends to deal with contestability in the default retirement benefit market. This is important to ensure:

- a proper evaluation of alternative default models
- the right criteria are used to evaluate default funds within whatever model is adopted
- the development of the CIPR framework and regulations are properly framed.

This paper identifies three approaches for addressing the contestability of default funds. Under each option, the member is free to leave the default fund at any time.¹ An outline of each option is provided below and summarised in the Table 1.

Table 1: Contestability of Default Retirement Members - Summary of Alternatives

Option	New Super Members (Accumulation)	New Retirement Members (Decumulation)	Implications for Policy Processes
Option 1: Accumulation only	Contest	No Contest	No contestability for retirement benefit market. Default members on their own (status quo).
Option 2: Two-Stage	Contest 1	Contest 2	A second default model, separate from the one applying in accumulation, would need to be created for the retirement system.
Option 3: Integrated	Single Contest		Retirement phase included in evaluation of alternative default models, and retirement benefits included in criteria for evaluating default funds.

¹ Certain conditions may apply if they chose to leave during retirement and they are in a default fund that includes a longevity risk pooling component



Accumulation-Only Approach

Description:

Under this approach, contestability is provided only for new default members joining the workforce. The market for retiree default members remains uncontested and default members remain in their existing fund.

Evaluation:

- Relies on product disclosure and product comparability which have not proven to be very effective to date. Would do nothing to help retirees with low financial literacy who are default members.
- With the government looking at strengthening contestability in the accumulation phase, it would be anomalous to leave default retirees on their own at precisely the time when their need is greatest.
- Inconsistent with other government policy positions, namely making retirement income the objective of superannuation and facilitating comprehensive income products in retirement.
- The absence of a retirement benefit solution may make funds unviable due to net outflows which reinforces the risks of considering the accumulation phase in isolation.
- This approach could be seen as the status quo, or 'resolve it later approach', only worse. Default members in the alternative default super model arrangements under consideration by the PC may well be even less well prepared for the decisions they are required to make at retirement than they are under current arrangements.
 - This could arise because default members would remain in the same fund throughout their working life unless they choose to switch. Therefore, default super providers have little incentive to encourage member engagement because only an engaged member can make the choice to leave the fund.
- To try to extend the alternative default model to include retirement benefits once the system has been established would result in legacy products and indeed legacy members who will be unsupported at retirement.

'Two-Stage' Approach

Description:

The PC's development of alternative default model applies only to new superannuation members during accumulation. Under the two stage approach, separate contestability arrangements would be created for default members at retirement.

Evaluation:

Arguments in favour:

- Addressing the contestability of the accumulation and retirement phases separately could arguably result in two models better tailored to each phase of the superannuation system. This could also facilitate the specialisation of superannuation funds into accumulation and retirement benefit funds.
- If an alternative default is adopted that leaves the ultimate choice of default from a shortlisted menu to the individual (model 1), it could be argued that young people are not well placed to take into consideration retirement benefits in their choice of default, lending weight to a separate contest at retirement.
- A shorter term consideration is that this approach would enable the contestability of the accumulation phase to be developed without the added complication of including the retirement phase.

Arguments against:

- It ignores the fact that the purpose of superannuation is to provide retirement income and would inhibit the development of whole of life default super products.
- The absence of a retirement benefit solution may make funds unviable due to rising net outflows resulting from an aging population which reinforces the risks of considering the accumulation phase in isolation. While young people are not well placed to take into consideration retirement benefits in their choice of default, pre retirees in default funds are unlikely to be better placed to do so without support. This has a bearing on the evaluation of alternative defaults.



- Splitting contestability of default models for accumulation and retirement would create unnecessary duplication leading to inefficiency. Separate systems would raise the need for integration which is avoided by the single stage approach as outlined below.
- The PC draft report does not contemplate a mechanism for introducing contestability to member defaults at retirement, leaving the process for developing this component unresolved.

Single-Stage Approach

Description:

This would involve the development of an integrated alternative default model for all new default super members that applies from the time the member enters the super system and continues through accumulation and retirement phases until the death of the member. Under this approach, a fundamental criterion for the selection of super default funds would be the provision of retirement benefits.

Evaluation:

Arguments in favour:

- Recognises that the purpose of superannuation is the provision of retirement benefits and ensures a better integration of accumulation and benefits stages of the superannuation system.
- Facilitates the development of 'whole of life' super products focused on the ultimate outcome of retirement income comparable to defined benefit schemes. Rather than a discrete accumulation phase followed by a decumulation phase, this avoids a forced and high risk point-of-sale in the transition to retirement and facilitates projecting benefits in terms of income.
- From a behavioural perspective, it would serve to anchor benefits as a lifetime pension.
- Enables a more streamlined and efficient process than the 'Two-Stage'. Ensures that providers are focussed on the income stream in retirement consistent with the government's objective of super.
- The alternative default model selection process could support the government's intention of facilitating trustees' provision of CIPRs by including retirement benefits as a key selection criterion.
- Making it clear from the outset that the alternative default model is to apply to the retirement phase would encourage trustees to give greater priority to the development of CIPRs and engage in the CIPR policy development process.

This approach would also be consistent with the terms of reference for the PC Inquiry that (emphasis added):

*"(T)he 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.**" (PC Draft Report, Superannuation Alternative Default Fund Models, 2017, pvi).*

Arguments against:

- Young people are not well placed to take into consideration retirement benefits in their choice of default

