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First State Super – Submission

Superannuation: Alternative Default Models

Productivity Commission Issues paper, September 2016

28 October 2016

Introduction

As one of Australia's largest superannuation and retirement incomes funds, First State Super is a profit-for-members fund responsible for the accumulation and pension savings of 770,000 members, managing over $75 billion in funds (including State Plus). We have a strong interest in the future of our members who are the people whose lives are often dedicated to helping others – nurses, teachers, emergency services workers and public servants. First State Super is committed to its member community and to the national interest as we believe both are intrinsically linked.

First State Super submits the following responses to the Productivity Commission's Issues Paper - *Superannuation: Alternative Default Models* (the Issues Paper).

First State Super has contributed actively to ASFA's and AIST's consultation processes and submissions. We concur with both associations on positioning members' best interests as the key criterion for default selection, and on the Administration Model as the preferred approach. We also agree with their positions on:

- the unsuitability of the Market Tender Model, which appears on first appraisal to be free of bureaucracy and paternalism, but may be more costly than a government filter, especially if it resulted in short-termism, gaming and the erosion of public confidence in compulsory superannuation. These outcomes would mean a market tender model would be, on balance, either more costly than a government tender or unfit for purpose;
- the complete unsuitability of a Member Choice Model, especially for younger people who are inexperienced in dealing with complex financial products and regulations.

Our submission is focused on ensuring a multi-dimensional assessment of the superannuation system in total and defaults in particular, and expands on matters we regard as important for our members.

We note the importance of:

- A wide definition of members' best interests to ensure assessment for selecting default funds does not rest on a single decision factor, such as fees or net returns;
- Advice, whether in the form of information, education, intra-fund or face to face personal advice in improving members' involvement and retirement outcomes; and
- Scale as a key measure for default funds, particularly in profit-for-members funds which realise the benefits of scale for members, noting that the largest 30 super groups already attract 87% of both employer contributions and FUM (as at 30 June 2015).

Our comments support both members' long-term personal financial interests and the national economic interest. We welcome the opportunity to discuss our views further.

Members' best interests - criteria of assessment

We broadly support the Commission's criteria for assessing the alternative models (page 7 of the Issues Paper), and support the notion of building on the good base of the MySuper regime.

In particular, we support the primacy of members' best interests. Nonetheless, we submit that the "members' best interests" criterion should be broadened beyond a) long-term net returns and b) allocation to products that meet their needs.

Definition of best interests

We suggest a more detailed articulation of what it means to "meet members' needs" within the superannuation system. The relationship between a member and their fund is generally characterised as long-term and based upon trust and engagement rather than short-term and transactional. As such, "members' best interests" should include at a minimum:

- Member support services such as member service centres, education services, self-service tools and calculators, income stream benefit projections, intra-fund advice – potentially including 'robo-advice' and access to full advice services;
- Access to additional investment products at similar fee levels to the default product;
- Group insurances, preferably tailored by relevant segmentation such as employer or occupation; and
- Quality of fund governance.

We also re-iterate the Terms of Reference in specifying a "focus on expected after-fee returns *based on asset allocation and investment strategy* [emphasis added]" given the importance of funds' ability to access scale investments such as infrastructure, direct property or other unique long-term assets. These very large assets are often not available to self-managed super fund members or smaller funds. In addition, these long-term assets are well suited to the long-term nature of superannuation savings as part of a diversified portfolio.

We support the importance given to the criterion of fund stability, given its direct impact on members' best interests over the long-term.

The importance of defaults

We acknowledge the Commission's chosen base-line of no defaults; however, we note that the compulsory nature of the superannuation system addresses, to a large degree, the fundamental problem of hyperbolic discounting and myopia with respect to saving and planning for retirement, where people are reluctant to forgo a present value for a higher future value. As a result, the opportunity for 'nudging' employees at the point of commencement is largely superseded.

In our view, a significant weakness of a "no defaults" model is that compelling employees, particularly young employees entering the workforce, to make a highly complex financial decision, will result in decision making dominated by "rules of thumb" or heuristics, and be vulnerable to mis-selling, which in turn will negatively impact their retirement outcomes. From a member choice perspective, there are two benefits of a default system:

- it can reduce number of funds for consideration which reduces search costs and also overcomes the problem of choice overload[1], and relatedly
- it can lean against the use of intuitive rules of thumb by employees, such as brand awareness, advertising and promotions, and increase efficiency by structuring competition around features which are in line with members' best interests.

It is also for these reasons that we support the Administrative Model proposed by the Commission. We think this model is less open to being gamed than the Market Tender Model, and we reject the Member Choice Model on the grounds that early in working life, and at other stages in working life, many members benefit significantly from being placed in a default fund.

[1] Sheena S. Iyengar, Jiang, Wei and Huberman, Gur (2003) 'How Much Choice is Too Much?: Contributions to 401(k) Retirement Plans', *Pension Research Council Working Paper*, funds that "participation in 401(k) plans is higher in plans offering a handful of funds, as compared to plans offering ten or more options…" For Australian evidence see Josh Fear (2008) 'Choice Overload: Australians coping with financial decisions', Discussion Paper Number 99, The Australian Institute.

In short, our view is that the benefits of defaults, whether determined by government filter, enterprise agreement, modern award or other award, by employer nomination or by other means, help members into appropriate products. We support the notion of individual members being able to exercise their personal choice of either investment option or alternate fund, within a default model where members can still access the benefits of a high-quality, high-returning and low-cost default fund.

Advice in default fund models

Our fund has focused on providing a range of education and member services throughout its history, and while members may appear to be dis-engaged, we notice a high level of reliance on the information and support we provide, especially as we field an average of 35-40,000 calls per month from members, and approximately 40,000 web logins per month.

Long term relationship

Superannuation entails a long-term relationship between an employee and their fund. This is due to the long-term nature of retirement saving and planning, the importance of long-term thinking in terms of investment strategy, the compulsory nature of superannuation and the psychological habits of inertia and anchoring. Over the long time period of a working life, the needs of members change and develop, as do their preferences regarding risk and the saving-consumption trade-off. Awareness and experience of saving, superannuation and financial literacy also change and grow according to life stage and financial expectation.

Hence, we submit that an allocative model for new default members must have regard to the spectrum of information, education, tools and advice provided at low cost by successful default funds to all members. We are concerned that focus on the product attributes of the default product, at the exclusion of additional services, may remove less tangible benefits from members.

Advice and decision making

As “robo-” or digital advice evolves over the coming five years, more members will be able to seek advice and assistance with planning their retirement at lower cost than face-to-face advice. Given the costs of development and implementation, digital advice services will be available to members of the largest funds. We regard these services as valuable to members, but they do not come without cost. We are also concerned that the Commission’s proposed model of ‘forced’ member choice may inappropriately reduce the complexity of retirement decision-making to selected point-in-time views of the member.

- For example, the decision making required by a 20 year old for a 45 year timeframe is highly likely to be sub-optimal and may become simplified to a single focus on factors such as fees, asset allocation, brand, short-term returns, or another unsuitable proxy of member need.
- In contrast, the decision making of a 45 or 60 year old will be more informed by life experience and financial knowledge, and the need for information and well qualified advice means that this group is more likely to seek assistance – even if only over the phone. In other words, we believe there is benefit in providing a model which assists with the complementary but different processes of mass accumulation and individualised retirement planning.

For these reasons, we wish to include the broader information, education and advice services as integral to selection of default funds.

Behavioural finance

In addition to the above comments, and in response to the Commission's interest in behavioural finance, we make the following observations. Behavioural economics has proved valuable in resolving problems where choice and traditional market models fail to achieve optimal outcomes. It can be useful in helping members overcome the dangers of overconfidence, bias to the familiar, inertia, and other information biases, such as regarding success as arising from personal skill and failure as a consequence of bad luck (or other external factors).[2]

On balance, the evidence supports auto-enrolment or compulsion in the first instance, supplemented by measures to boost patterns of savings which continue without constant re-evaluation by the saver.[3] Auto-enrolment is in itself a 'nudge' because saving for retirement requires long-term thinking, the products and solutions are complex, and the process has a value which is inherently difficult to determine. The Australian retirement system already applies these key conclusions through compulsory superannuation.

We see value in programs such as the "Save More Tomorrow" campaigns in the US and UK where people who committed to *future* increases in savings rates did not opt out of that commitment and successfully increased their savings.[4] The insights of behavioural economics can have a large impact on the retirement outcomes of Australians. Once members are in the system, they can be 'nudged' to change behaviour and make decisions to improve their retirement outcome.[5] For example, our recent internal pilot of sending retirement income projections to members, rather than balance projections, increased both engagement through use of retirement income calculator and positive behaviour, with 10% of those invited to join the pilot, and 90% of those viewing the projection, making additional new voluntary contributions and roll-ins.

Once members are in the system, behavioural finance can help all members to access the benefits of advice by applying behavioural insights to information, education and advice provided by funds. On balance, behavioural finance provides valuable insights to influence members' value positively; however, we would be very concerned if the nudges and framing lessons from behavioural finance were used to influence people to move away from high performing, low cost funds to funds or solutions which are not necessarily in their best interests.

Scale

There are important relationships between contribution flows, fund size and scale in Australia's superannuation system. We submit that the Commission should have regard to these in designing alternative default models.

Performance

APRA researchers have found "strong evidence that the performance of profit-for-members superannuation funds improves with fund size."[6] This was found not to be the case for retail funds. The researchers suggest that members of retail funds may not be benefitting from realised economies of scale due to the structure of retail funds as platforms from which members choose from an array of products, higher investment expenses and the use of related party investment managers, and the absence of reduction in variable costs.

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[2] Richard Thaler and Cass Susnstein (2009) *Nudge: improving decisions about health, wealth and happiness*, Penguin, London.

[3] Shlomo Benartzi (2012) *Save More Tomorrow: practical behavioural finance solutions to improve 401(k) plans*, Potfolio/Penguin, New York

[4] "The right nudge for human investors", *Investment principles,* Robin Bowerman, 15 Feb 2016, Vanguard website, sighted on 25 October 2016 at https://www.vanguardinvestments.com.au/retail/ret/articles/insights/research-commentary/investment-principles/The-right-nudge-for-human-investors.jsp

[5] Shlomo Benartzi (2012) *Save More Tomorrow: practical behavioural finance solutions to improve 401(k) plans*

[6] James Richard Cummings (2012) 'Effect of fund size on the performance of Australian superannuation funds', APRA Working Paper, p 3

These findings suggest that funds receiving default or employer contributions can design product and service offerings and investment strategies which leverage these flows to the benefit of members in terms of net returns. We also submit that service offerings need not be characterised as either entirely 'disengaged default' or overly 'engaged retail' (in fact these groupings are unhelpful). Service offerings exist on a spectrum along which scale benefits can be realised for members in a number of areas such as education, digital self-service tools and intra-fund advice.

It is important to recognise the complex relationship between fund size, scale and product offering. A model for defaults which has the simple effect of increasing fund size through consolidation will not guarantee realised benefits for members. As the APRA research found, retail funds had sufficient size to achieve economies of scale but these were not realised or passed on to members. Equally, retail funds also receive significant shares of employer contributions, despite much commentary claiming the opposite (to the extent that these are default contributions is impossible to determine with any accuracy, though they may include employer nominated defaults as opposed to industrially determined defaults).

Existing concentration and scale

We note that there is a high concentration of employer contributions flows and total FUM in the largest funds and Groups. Based on 2015 APRA data[7], 20 individual funds receive 76% of all employer contributions. This includes five industry funds, two public offer government funds, and three retail funds in the top 10 funds. Eight of the top 20 individual funds are retail funds – suggesting effective competition.

When we analyse the data by RSE and consolidate the funds' data to group level (eg, combine BT and Westpac, CBA and CFS, and include Plum with MLC), the concentration is more apparent with 80% of all employer contributions received in the top 20 funds/groups. It is worth noting that four of the five major retail providers are represented in the top 10 groups receiving employer contributions. This highlights to us the importance of scale in achieving an efficient (already competitive) superannuation system.

Super Groups	Total FUM	% of total FUM	Employer Contributions ($'000)	% of total employer contributions
Top 10 Groups	718,327,821	59.8%	35,130,702	59.4%
Second 10	238,428,267	19.8%	12,416,989	21.0%
Third 10	85,731,967	7.1%	4,154,866	7.0%
Top 30 Groups	1,042,488,055	86.7%	51,702,557	87.4%
All groups	**1,202,178,421**		**59,170,572**	

Source: Analysis of APRA's *Annual Fund-level Superannuation Statistics*, June 2015

International comparisons

As a further comment on scale, we wish to raise a note of caution in relation to comparison with international models. While previous public analysis has suggested Australia's system is more expensive than international comparators, there are many differences, including those we note about members' best interests and advice and guidance.

[7] APRA *Annual Fund-level Superannuation Statistics*, data to 30 June 2015, analysed & grouped by RSE

The Australian system is heavily regulated and carries high compliance costs (eg Stronger Super), not matched in international systems. We are particularly concerned about any future introduction of an auction-based model which focuses solely on the criterion of low fees as we expect this to lead to a reduction in member services and a drop in the economic viability of the industry over the medium to long term.

As already noted, large scale Australian funds have made major investments in infrastructure in this country and are contributing to venture capital and innovation, which would not necessarily continue in a lowest possible cost model such as the Chilean model.

Summary

In conclusion, we submit that, based on members' best interests, the Administrative Model is most likely to achieve the best outcomes; it will be least likely to be gamed or be subject to market collusion, and it is more likely to ensure a viable long-term proposition for the nation. We note there will be many operational issues to resolve in transition.

In summary:

- We submit that the criterion, "members' best interests" should be broadened to include a range of member services to help members understand their superannuation and hopefully to build on the basic support from the government (ie, taxation relief and compulsion).
- We support members' best interests with respect to the benefit of advice which we think the best funds can provide from members' early accumulation years, through transition into retirement. This is especially important for members who may not wish to seek formal financial planning advice.
- Finally, we believe that understanding the existing scale dynamics in the superannuation industry will help in optimising default models in the future.

We look forward to working with the Commission in the coming stages of this inquiry.