Risky business:

Why the proposed models would not protect members

SUBMISSION REGARDING ALTERANTIVE DEFAULT MODELS

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Industry Super Australia

ABOUT INDUSTRY SUPER AUSTRALIA

Industry Super Australia is a research and advocacy body for Industry SuperFunds. ISA manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of over five million industry super members. Please direct questions and comments to

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EXECUTIVE SUMMARY

Industry super funds have a track record spanning many years of acting in the interests of members, and of promoting reforms to public policy in the interest of members.

Some examples include:

- Removal of conflicts and commissions from the provision of financial advice[1]
- Stronger default fund selection rules focused on net performance which would eliminate from selection poorer performing funds[2]
- Automatic consolidation of multiple accounts[3]

In addition to being proponents of a better super system, industry super funds have delivered superior long term net returns to members. For as long as performance data has been collected, average industry super fund performance has exceeded the system-wide average, and the OECD average.

We support some aspects of the Inquiry's Draft Report regarding Superannuation: Alternative Default Models (the Draft Report), and in many instances recommend stronger action. We would encourage the Inquiry to go further than its Draft Report in addressing the following areas:

Reduce the number of multiple accounts, not just the proliferation of multiple accounts

To reduce the proliferation of multiple accounts, the Draft Report recommended that an individual join a default fund when they begin work, which would remain their default fund unless and until they choose a different fund.

We recommend a different approach to the proliferation of multiple accounts: a member's benefits should transfer automatically when they change employer. This mechanism avoids some of the key risks in the Inquiry's draft proposal, including the risk that the initial default fund a person joins when they begin employment might not be ideal later. Our recommendation results in the same outcome as the Inquiry's proposal: members who enter the super system in the future will have one account unless they affirmatively choose to have more than one.

We recommend that the Inquiry go further than it did, and propose reforms to address existing multiple accounts. We recommend vigorous, automatic account consolidation whereby accounts which have been inactive for one year are automatically consolidated into the member's largest active account unless the member affirmatively decides to retain the inactive account to enable those who have decided to have more than one account to do so. In addition, member communications to inform them of auto consolidation should be neutral information only, not sales or solicitation material which seeks to encourage the member to keep the inactive account open.

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[1] Industry Super Network, Submission to Treasury Future of Financial Advice Consultation, Proposals for best interests duty, April 2011

[2] Industry Super Network, Submission to Productivity Commission Inquiry – Default superannuation funds in modern awards, 5 April 2012

See also, "Call to axe dud superannuation funds", *The Australian,* 11 April 2012

[3] Industry Super Network, Submission to Super System Review Phase 2: Operation and efficiency, 21 December 2009.

These matters are discussed in more detail in Section 2.1.

Expand the protections of the default system to retirees, not just working members

We recommend that the Inquiry embrace the consensus that the superannuation system should shift from one focused on savings to one focused on delivering retirement income. This means that the member's experience is of a single, whole-of-life default, in which the transition into the payment of retirement benefits is seamless. Without suggesting anything about the underlying fund operations or product structure, as innovation in this area may continue for some time, a good experience for the vast majority of members might resemble that typical of the members of defined benefit plans: instead of a complex point-of-sale at retirement focusing on products, the member in a whole-of-life product simply confirms their retirement and might engage on a few simple elections about the benefit they will receive (such as what commutation or lump sum they would like at retirement and whether to receive a spousal reversionary pension).[4] As demographic change proceeds and members increasingly receive regular income payments from superannuation, a strong default system comprising the best performing funds that manage savings as well as deliver retirement income will be of growing importance.

It makes little sense – other than path dependency – to default members into an accumulation product in a retirement income system.

We note that a whole-of-life product is a core feature of the best performing private funded retirement income systems around the world.

These matters, including our responses to the points raised regarding this issue in the Draft Report, are discussed in more detail in Section 2.2.

Ensure those who exit the safeguards of defaults only do so when they are better off, not because of sales

The Draft Report acknowledges that there are substantial behavioural risks relating to retirement income, and that cognitive biases and limitations mean disclosure and financial literacy efforts are insufficient to ensure members are protected from providers who want to maximise profits for their shareholders and themselves.

Yet the Draft Report did not address the risk that for-profit providers will continue to seek to extract value from members. The Draft Report continues to promote a superannuation system in which sales (i.e., "choice") is central.

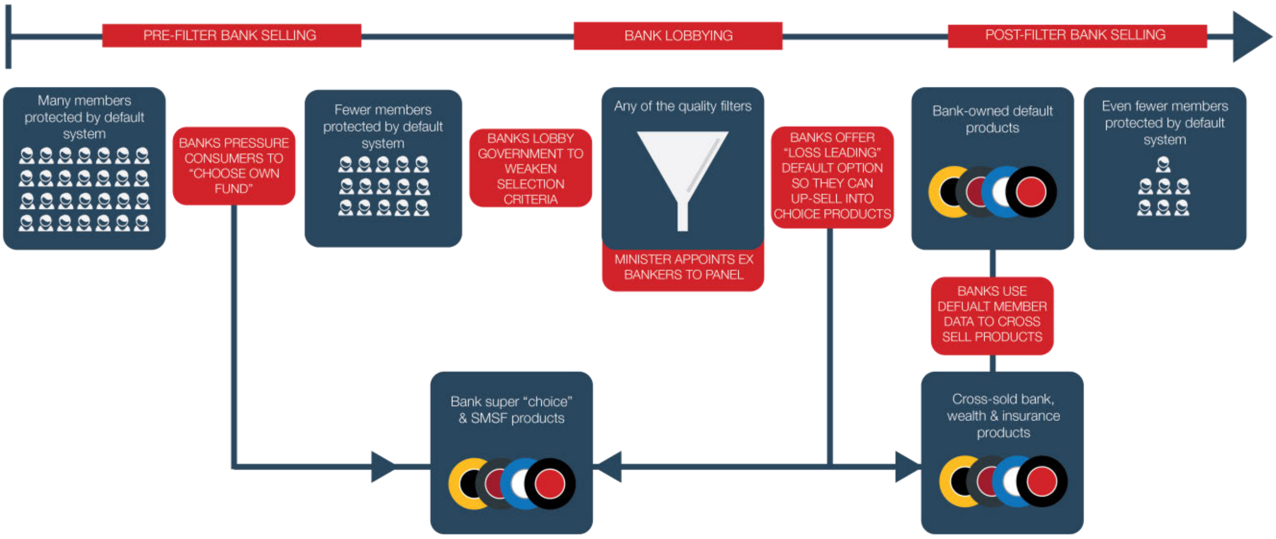
Any default system proposed by the Inquiry should protect the members in it against sales efforts to switch them into lower performing products. They should include prohibitions on up-selling and cross-selling by any default provider (and its affiliates) as discussed below, and limitation on the efforts of other providers.

We encourage the Inquiry to consider a range of options, such as:

- A *Better off test:* a requirement that providers do not provide advice or solicit a member acquisition unless the provider has reasonably determined that the product would leave member would be better off from a financial point of view, and
- An *Earned profits requirement*, which would seek to better align the interests of fund members and providers. It would require a superannuation fund (or the average member of that fund) to achieve above-median net returns for a specified period before profits from the superannuation business of which the fund is a part is allowed to pay profits to the business's shareholders. In this way, shareholder profits would have been "earned" through outperformance.

[4] These member elections would have been informed by regular disclosures leading up to retirement projecting the member's retirement income.

Figure 1 – How the Draft Report proposals are vulnerable to the banks



Source: ISA

The treatment of so-called "choice" members in retail funds and SMSFs is the greatest failing in superannuation. Members of retail "choice" super products receive lower long term net returns than not-for-profit default funds.

The long term net returns to members of most SMSFs are even lower.

It is very difficult to believe that the millions of people in retail choice products and SMSFs have affirmatively chosen to be poorer.

But that is the implication of the Draft Report, which clings to ideas connecting individual agency to financial product choices that began to lose credibility before the Wallis Inquiry, over 20 years ago, and have no credibility today.

Forcing or encouraging disengaged members to choose their own fund and to make investment decisions is a high risk experiment that is supported by the banks. This is because it suits their business model. Yet there is no evidence to indicate doing so will increase effective engagement, financial literacy, or, most importantly, financial outcomes.

Ensure that the superannuation system retains industrial parties to avoid being further captured by the finance sector

Australia's private retirement income system is unique among Anglophone countries – but not OECD countries – in the degree to which the industrial parties are major stakeholders and, as a result, a significant portion of the system is operated by not-for-profit providers.

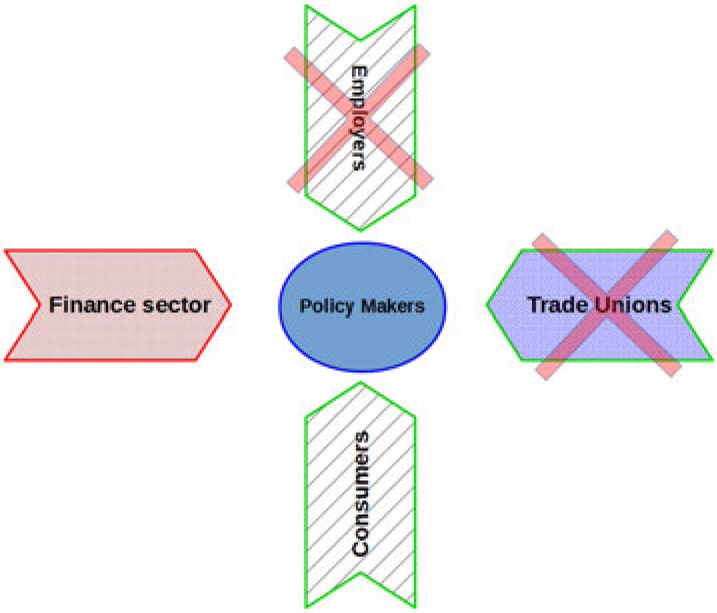
As explained further in Sections 3.1.5, 2.4 and 3.1.4, the banking and finance sector has significant influence in Australia and in other countries with high levels of financialisation. Research by political scientists has found the effectiveness of finance sector lobbying depends in part on the counter-strength of other organisations, particularly industrial parties.[5]

In contrast, consumers alone have been unable to counterbalance the finance sector where industrial parties are weak. Nonetheless, the Draft Report eliminates any formal participation by trade unions in default fund selection, and eliminates any formal participation by employers in all but one model.

[5] See, e.g., Witko, C. (2016). The Politics of Financialization in the United States, 1949–2005. British Journal of Political Science, 46(2), 349-370 (describing the strength of financial sector lobbying, its success when organisations with the capacity to resist it are weak, and particularly noting that "the share of income going to 'rentiers' (that is, investors in the financial industry) is highest in Organisation for Economic Co-operation and Development (OECD) countries with the weakest labor unions.").

Moreover, a system predicated on individual responsibility leads consumers, upon learning of a lower retirement income or return, to blame themselves rather than the system's design, and the accommodative approach it takes to providers.

Figure 2 – The Draft Report removes the industrial parties from super, risking the domination of policy formation by the finance sector



Source: ISA

The Government's decision to seek an alternative to the Fair Work Commission default fund selection process is not based on an objective assessment of the current system's merits because the process has not been tested. It should be noted that the major banks are the principal opponents of the Fair Work process.

Recognise the vital importance of culture in superannuation and strengthen it

The Draft Report's proposals are at risk of promoting a culture in superannuation that prioritises profits to firms and shareholders rather than prioritising the interests of members based on a culture of serving others.

As discussed below in Section 3.2.3, the Draft Report is based on a view of human motivation and culture – "homo economicus" – that is decades old and has been empirically rejected. The Draft Report seems to insist on superannuation being a "market-based" system, in which "competition" disciplines providers who are all assumed to be intrinsically selfish and manipulative.

This approach to policy is self-fulfilling. A system that calls on providers to "compete" to attract members expressly indicates that viewing members as sources of profit is acceptable, if not desirable, behaviour.

But a system based on values underlying "competitive" systems and concomitant selfishness and manipulation is not the only way. Industry super funds and other not-for-profit funds are different, and not only in terms of their performance. Industry super funds are different because of culture and values. And it is no accident that having a structure and a culture that exists to serve others is the key thread joining the best performing superannuation funds in this country and in the leading retirement income systems in other countries. A fund structured only to deliver for beneficiaries supports a strong culture. Cultural problems can more easily exist when loyalties are divided, particularly because the opportunity to act disloyally to members is high.

Consistent with global best practice, Australian not-for-profit super funds were organised to deliver the best outcomes for members.

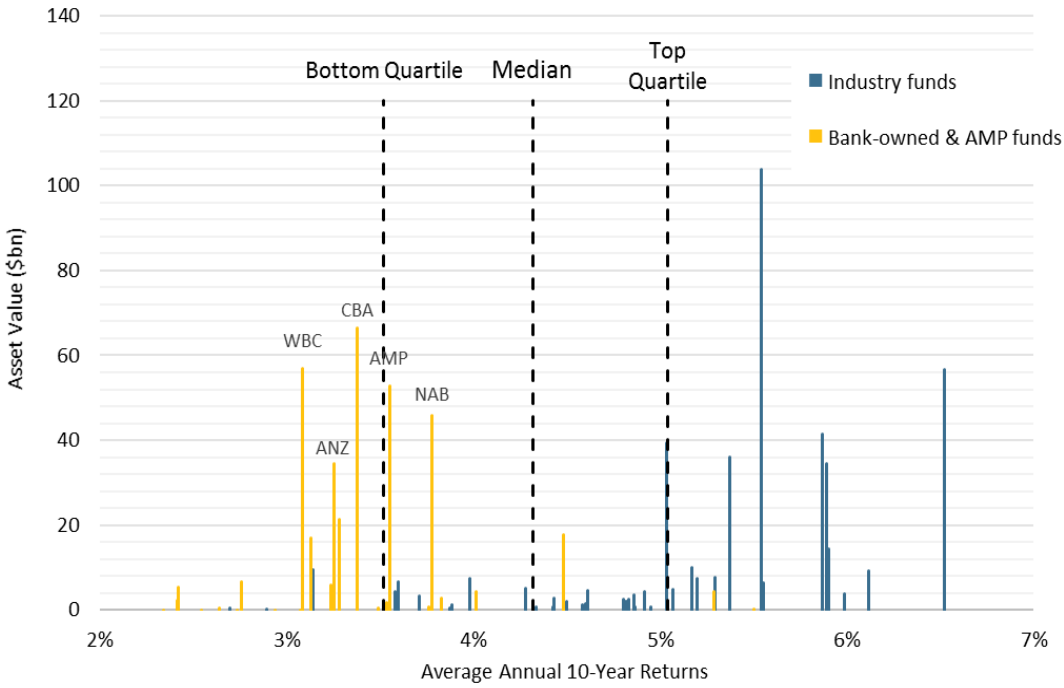
Superannuation resembles other areas of society where professional ethics and norms, supported by strong regulation, are needed to ensure good conduct. Society does not use competition and market forces to discipline professionals, such as doctors. This is because, as in super, individuals are not well-suited to manage their own medical care and should be able to rely on their doctor to act in their interest. Professions such as medicine require a high degree of accreditation, are heavily regulated, and enmeshed in a set of cultural norms based on serving others.

The culture of "prudent fiduciary" in superannuation is being subject to ongoing dilution by efforts to make it a retail financial service, in which banks and others can "compete" to extract value from members. The proposals in the Draft Report would continue to undermine the prudent fiduciary culture by signalling that members are a resource to be exploited upon winning the "competition" or auction.

Stronger action to remove the barriers to mergers is needed, but the focus on consolidation is misplaced

The inference that smaller funds cannot perform well, or that large funds always do, is not true: the bank-owned funds are very large, and very poor performers over the long term (Figure 3).

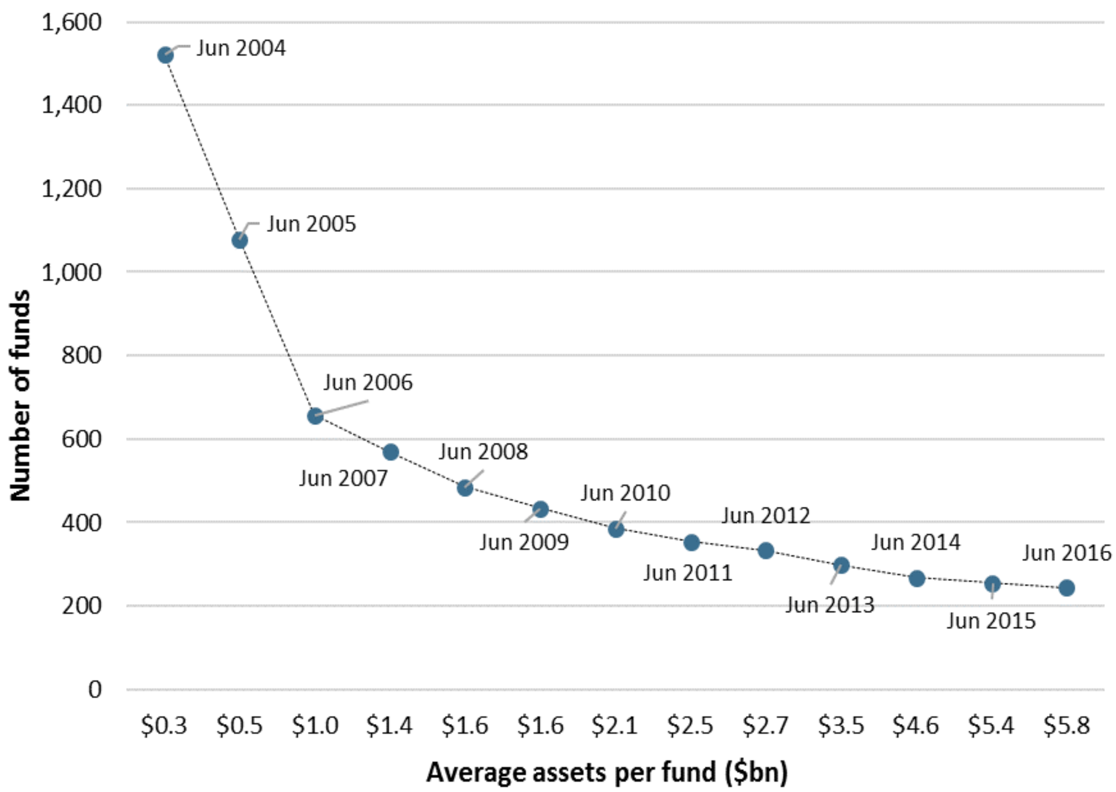
Figure 3 – Profit motive, size, and performance



Source: APRA Annual Fund-level Superannuation Statistics, June 2016, ISA analysis

At the same time, superannuation funds that have determined a merger is in the interest of members should be able to do so efficiently. This is not always the case today, but a substantial number of mergers and consolidations have still occurred among APRA-regulated superannuation funds over the years, as shown in Figure 4, below.

Figure 4 – Consolidation of APRA-regulated super funds



Source: APRA Annual Superannuation Bulletin, June 201g; ISA analysis

Nonetheless, there are barriers to mergers of APRA-regulated funds resulting in such transactions not being more difficult than they could be. However, these barriers are not the ones identified by the Draft Report.

The barriers to merger include legal uncertainty about the scope of the equivalent rights requirements, tax implications, and other factors.

A lack of transparency is not a barrier: the duties to carefully consider mergers and to provide transparency are already strong. Trustees currently have: (i) a duty to give genuine consideration to the merger approaches; this duty is encompassed in the SIS covenants (section 52(2)b and 52(2)c), and (ii) a duty to disclose material or significant events, this duty is encompassed in section 1017B of the Corporations Act.

The Inquiry did not discuss these existing requirements and explain how the proposed disclosure requirements would be an improvement.

There are risks with the Inquiry's proposal. It would require disclosure of all "merger approaches", regardless of whether they were material, or reasonable, and potentially well before materiality could be assessed.

The proposal would also give third parties who do not have a duty to members the ability to trigger disclosure that could create a perception among members, regulators, plaintiff lawyers and other market participants that a superfund is "on the market" or "being shopped".

In place of the Draft Report's recommendations, the Inquiry should instead remove the real barriers to the ability of trustees to execute mergers of super funds and consolidation of scale-sensitive aspects of superfund operation.

The Inquiry should also make recommendations to rationalise the SMSF sector, which has seen a significant increase in the number of funds, and a decrease in the average size of funds, while generating lower net long term returns than APRA-regulated funds. These data indicate that the SMSF structure is inefficient, and suggest the structure increases collective action problems.

Each of the proposed models is acutely vulnerable to up-selling and cross-selling by the banks

The Draft Report envisions a system where private sector for-profit financial institutions can bid for and win pools of default superannuation members. Such an outcome would deliver to the for-profit part of the super system a ready-made, government-sanctioned customer base at a very low acquisition cost.

Once this customer base is acquired, these institutions will up-sell and cross-sell other products. Today, sophisticated members under professional advice enter into these products, and wind up poorer. Yet the proposal in the Draft Report would furnish for-profit institutions with a customer base of less engaged default members, who are likely to be even more susceptible to being sold products that may not be in their interests (and leave them worse off overall).

Many banking products such as credit cards and insurance don't have any best interest duty attached. Many of these products are high margin (e.g., credit cards) and there is an unacceptably high risk that such institutions will seek to influence the selection process, as well as loss lead into the selection process, so they can obtain these customers and sell other products to their newly (and cheaply) won customer base.

This commercial imperative (and reality) is one of the most acute risks in the Draft Report's proposals.

At a minimum, any model proposed by the Inquiry should expressly prohibit default fund trustees and their related parties from up-selling superannuation products, and cross-selling other products. These prohibitions will need to be backed by a very well-resourced compliance and enforcement effort, which would need to make periodic public reports on its endeavours.

However, the practicality of implementing such prohibitions and enforcing them, is open to doubt. The commercial imperatives involved will result in an inexorable effort to erode the prohibitions. These efforts will begin during the legislative stage, and if effective laws are enacted, will be eroded mercilessly through "financial innovation" and regulatory arbitrage over time.

The Inquiry proposed no protections for consumers being sold products that transfer them out of the default safety net, nor did it consider how banks' up-sell and cross-sell strategies would undermine each of the proposed selection processes.

Other concerns with the models

We recognise the limitations of the Terms of Reference provided to the Inquiry, however the models that have been developed are questionable on their face, and when reviewed in increasing detail seem more and more troubling.

Some of the flaws in the models include:

- Each of the Draft Report's models assume a higher level of consumer capability and capacity for sustained individual agency regarding superannuation products and their providers than exists.
- Each of the Draft Report's models is quite vulnerable to exploitation by bank-owned and other for-profit super providers, as outlined in Section 3.1.1, *passim* in 3.2 and 3.3, and illustrated above in Figure 1.
- The Draft Report proposed no protections for consumers being sold products that transfer them out of the default safety net, nor did it consider how banks' up-sell and cross-sell strategies would influence their behaviour in the selection processes.
- The Draft Report's proposed selection panel could lack accountability, and could be susceptible to influence, distorted incentives and politicisation. The selection panel would not be persistent, but would instead be appointed episodically by the Minister. A panel that dissolves shortly after selecting

default funds means the panellists could be offered inducements in which providers seek to influence the outcome in a favourable way by offering a panellist future rewards or employment directly or indirectly. In addition, because the panel will be dissolved shortly after default funds are selected, it is not clear how panellists could be accountable for bad decisions.

- If the Draft Proposals were implemented, over time there would be no natural counterweights to banks and the finance sector. Under the current system, trade unions and engaged employers can help well-intentioned public servants limit the influence of the big banks and wealth management firms. Under the Draft Report's proposals, the selection panel may be comprised of ex-bankers[6] appointed by the Treasurer. The Draft Report's proposals would eliminate trade unions from participating in default fund selection, as well as employers (except for one model).

The methodology adopted in the Draft Report is not persuasive

In developing alternative default systems, a compelling methodology would have looked for real-world examples of high performing private funded retirement income systems, and considered whether and how to incorporate the key aspects of these systems in Australia.

This approach would have not only provided an empirical basis for the Draft Report's proposals, but it would have forced the proposals to address practical issues such as profit motives of providers and the importance of industrial parties and other non-governmental organisations in disciplining providers and helping to maintain a good retirement income system.

Instead, the Inquiry's methodology has prioritised abstract reasoning over empirical evidence.

Prudent persons could not reasonably support the Draft Report's models because they lack a strong factual basis sufficient to clearly and concretely justify the costs and risks of change to a well-performing model recently ranked third in the world.

Organisation of the submission

- The general methodology of the Draft Report and the process of the Inquiry are addressed in Section 1.
- The areas where the Draft Report is on the right track, and should go further are addressed in Section 2.
- The features common to the models, such as the role of the ATO, are addressed in Section 3.1.
- Comments on the models are provided in Sections 3.2 and 3.3.
- Responses to the specific information requests set out in the Draft Report are in Section 4 of this Submission.

[6] Productivity Commission Draft Report, 'Superannuation: Alternative Default Models', March 2017, 210 (stating that "[T]hose 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.").

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1. The process and methodology of the Inquiry

Several procedural and methodological aspects of this Inquiry lack apparent logic:

- The Inquiry is developing alternative approaches to allocating default members to products without having assessed the current default system to identify what, if any, weaknesses exist. It is constructing solutions to unidentified problems. Logically, such an assessment should have preceded the current Inquiry. This is a consequence of the structure of the Inquiry, and responsibility ultimately lies with the Terms of Reference.
- The existing default system has not only delivered above-average long term performance, but also was only recently reviewed and revised. The revised system has not yet had an opportunity to proceed because the expert panel has not been appointed by Government. This is not the Inquiry's fault, but it unfortunately impairs the persuasiveness and procedural quality of the Inquiry.
- The Draft Report has ignored the best performing retirement systems in the world – Denmark and the Netherlands – when developing alternative models. This methodological decision is unjustifiable on the merits and seems impossible to explain other than because these systems are clearly strong due to (1) the participation of industrial parties, and (2) the exclusion of for-profit institutions. For-profit institutions desire an ecology that suits their business model, which is a system that encourages individuals to "choose" so that these individuals can be sold a product.

Table 1 - Private pension funds five-year and 10-year returns, net replacement rates, and adequacy rankings, selected jurisdictions

Country	Melbourne-Mercer Global Pension Index (2016) Ranking	Real 10 year-average net return to 2015, % pa[1]	Net replacement rate, Pillar 2[2],[3]	Adequacy Ranking[4]
Netherlands	A; #2 out of 27	3.8	63.4	1
Denmark	A; #1 out of 27	4.0	46.3	2
New Zealand	Not ranked	3.3	12.4[5]	10
Chile	B; #9 out of 27	3.5	32.8	40
Australia	B+; #3 out of 27	3.0	30.9	35
Australia: Industry Funds	Not applicable	3.7	*No data*	*No data*

The superannuation systems of Denmark and the Netherlands are widely regarded as the best in the world.

They are the only countries to receive an "A" rating in the Melbourne-Mercer Global Pension Index.

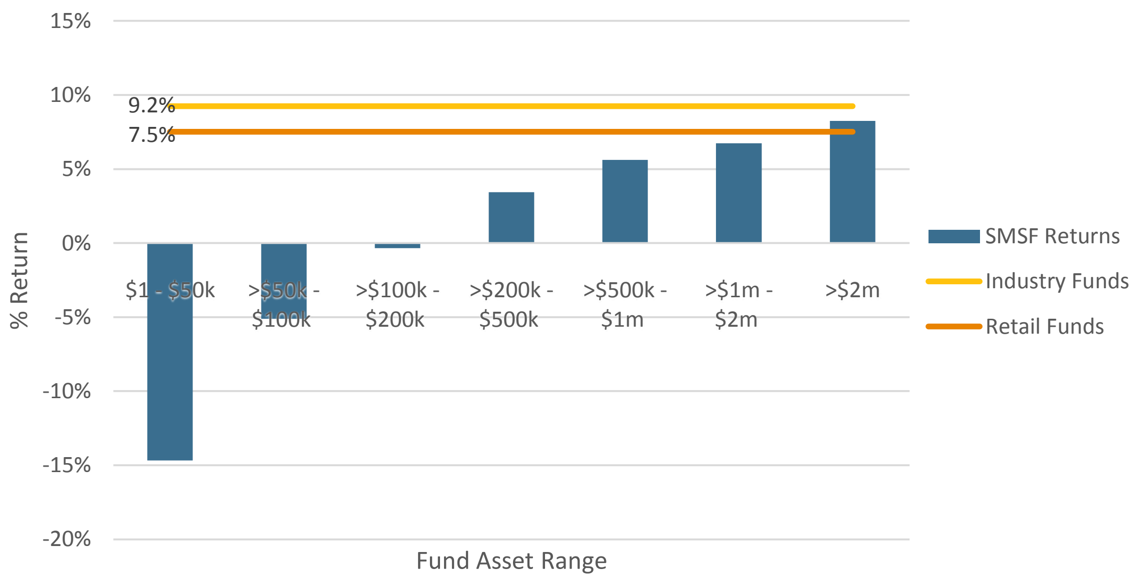
Yet the Draft Report failed to consider them.

Source: Source: OECD, Allianz, APRA, Melbourne-Mercer Global Pension Index (2016), ISA calculations
Note: (1) OECD (2015), except for Australia: Industry Funds, which is based on APRA data and ISA calculations; data for New Zealand is to 2014, the latest available OECD figures; (2) Replacement rate is for the year 2015, latest available OECD figures; (3) Replacement rate is for a median income earner for the year 2015, latest available OECD figures; (4) Allianz (2015); (5) New Zealand's replacement rate is for its "Voluntary DC" Pillar rather than "Mandatory Private" Pillar because the OECD data places KiwiSaver under the former category.

- The Inquiry has chosen to compare the proposed alternative models against a "no defaults" baseline that lacks analytical rigour because it cannot be empirically verified, but instead must be speculated. This weakness was demonstrable in the Draft Report's discussion of the baseline, in which some legislative and regulatory requirements were enforced,[7] others were not,[8] and new laws were created.[9] Many of the Draft Report's musings about the baseline are open to doubt.[10] It is not clear how the Inquiry can produce viable alternatives without assessing proposed models against the existing system. Sensible policy makers will struggle to consider an alternative to be "viable" unless the benefits of that alternative – relative to the existing default system we have today – clearly and concretely justify the costs and risks of change to a well-performing model recently ranked 3rd in the world.

- Each of the Draft Report's proposed alternatives not only promotes the "choice" market in superannuation, but seeks to extend it. This is troubling because (1) the retail choice and SMSF segments substantially underperform default funds, and (2) the retail "choice" and SMSF segment are substantial contributors to the profits of major banks and financial advisory businesses.

Figure 5 – Five-year annualised net returns to 2015



Source: ATO Annual SMSF Statistics, 2014-2015 (note returns data prior to 2012-2013 does not include non-deductible expenses) & APRA Quarterly Statistics 2016 Q3 (back-series used).

- No empirical basis was provided for any of the models proposed, nor was the baseline for assessment specified other than by conjecture. There are decades of experience with superannuation in Australia, and many times that across the advanced economies. Yet, instead of beginning with an assessment of what works and what does not work in the real world, the Draft Report has proceeded to develop models largely disconnected from any practical implementation. By relying on abstract neoclassical reasoning, the Inquiry has gone down a path toward Chile and New Zealand, whose retirement systems deliver inferior outcomes.

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[7] For example, the requirement to furnish disclosure (with no opt out).

[8] For example, the requirement to offer insurance on an opt out basis.

[9] For example, the requirement that employees make a choice of fund, with "significant consequences" for not choosing.

[10] The Draft Report appears to begin the baseline immediately, with an imminent switch from the status quo. And apparently with no notice to members or providers, because the baseline is utterly silent on how members and providers would prepare for the change.

In particular, the Draft Report was silent on market dynamics, such as how providers would fill the regulatory vacuum, the number of providers that would remain in business, how products would be marketed and promoted, or even how the public would react to the change from a default system to forced choice.

- The future of the superannuation system that would emerge from these models is unclear and unspecified under each model, making it impossible to respond meaningfully to many of the Draft Report's questions. How many members would remain in the default system after the first year? How many funds would exist outside of the default system? How would the Draft Report's proposals resist lobbying by the major banks? These and many other practical questions are neither raised nor resolved in the Draft Report.
- No formal cost-benefit analysis was performed for any of the proposed models, nor was there any effort to quantify costs or benefits. Seeking to perform a cost-benefit analysis would have helped clarify what the Inquiry believes would happen under the proposed models, and explain why those effects would occur. This would facilitate informed public commentary on the Draft Report.
- The Draft Report embraces the political worldview of "nudge" or libertarian paternalism without critically assessing it. Doing so would have shown that "nudging" is not optimal in superannuation. Yet, every model proposed in the Draft Report promotes consumer choice to exit defaults (and one model has no defaults at all, relying solely on "assisted choice"). The reasons why stronger policy than nudges is appropriate in superannuation include: (i) normative preferences are relatively homogeneous in superannuation such that a one-size-fits-most (or all) default or mandate can produce benefits for most people; (ii) choice errors are common and costly; and (iii) agency (in this context, agency is just the ability to select a specific financial product) is clearly not too highly valued at either the individual level (people do not invest a great deal of time or effort doing so except in response to selling pressures) or social level (policymakers are generally agnostic about providers and products, and instead focus on member benefits).[11] Nudges, just like mandates and other stronger policies, present the very same trade-offs between agency of individuals and welfare. The key question is whether the reduction in welfare arising from a "nudge" approach is worth the additional *perception* of individual agency.

[11] Cf., Finighan (2015), Beyond Nudge: The Potential of Behavioural Policy, Melbourne Institute Policy Brief No. 4/15.

2. Areas where the Inquiry should propose stronger reforms

2.1 Multiple accounts

Multiple accounts and the proliferation of multiple accounts is a significant problem.

We support strong policy reform to address multiple accounts (not just their proliferation), and suggest that policy makers go further than the proposals in the Draft Report. While it is true that multiple accounts are being reduced due to changes to public policy implemented in recent years (e.g., SuperStream) and the application of technology, more can be done.

As the Inquiry progresses this issue, it is important to properly diagnose the problem of multiple accounts. The Draft Report characterised multiple accounts as a “defaults” problem, exacerbated by compulsion. As explained in Section 2.1.1 below, this is not correct. Inactive accounts are present in all sectors, and are actually more common in retail funds than in not-for-profit funds. They arise due to behavioural factors regardless of how superannuation is distributed.

We also encourage the Inquiry to go outside of its terms of reference in other areas, not just to pursue the issue of multiple accounts and fund mergers – which are worthy areas for reform. Focusing scrutiny on for-profit funds and SMSFs, which are the greatest source of inefficiency in the superannuation system, would be a top priority for such investigation.

2.1.1 The Draft Report mischaracterised the problem of multiple accounts as a matter arising from defaults

The Draft Report characterised the existence of multiple accounts as a problem arising from the default system:

> 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 <u>due to the operation of the current default system</u> that potentially triggers the creation of a new default account with every change of job. (Emphasis added).

This characterisation is false, and even a cursory fact check would have made that clear.

Analysis of APRA data shows that the proportion of inactive accounts does not vary significantly by fund type (Table 2). The proportion of inactive accounts is actually higher in retail funds than it is in not-for-profit funds.

This indicates that the propensity for multiple accounts to exist is not a result of default distribution, since it occurs regardless of distribution mechanism.

About 23.9% of not-for-profit fund accounts are inactive. Over 32% of retail fund accounts are inactive. (Table 2).

This finding not only refutes the assertion that the issue of multiple accounts is a consequence of default distribution, it also underscores the reality of the behavioural risks in retirement income policy that the Draft Report does not take seriously enough.

Retail fund members have generally purportedly chosen their fund and products, and are often in receipt of personal ongoing advice. Yet about a third of retail accounts are inactive. This is a reflection of the reality that very few people value individual agency in superannuation (which also implies that whatever relevant heterogeneity, in circumstances and in preferences, may exist is not powerful enough to drive engagement outside of a sales interaction), yet many people are sold products that both underperform and deliver a profit to providers. That is what "choice" means in private retirement income systems.

Table 2 – Inactive member accounts

Fund type	Total number of member accounts at the end of period	Proportion of inactive member accounts	Proportion of lost member accounts
Corporate	336,395	15.2%	1.5%
Industry	11,117,691	25.5%	1.4%
Public Sector	2,607,988	18.9%	1.3%
Retail	12,966,434	32.23%	2.13%
All	27,028,508	28.1%	1.7%

Source: APRA Annual Fund Level Superannuation Statistics issued 1 February 2017

2.1.2 The Draft Report focused on reducing the *proliferation* of multiple accounts, but did nothing to address *existing* multiple accounts

There are about 7 million inactive accounts in the superannuation system. These inactive accounts are spread across retail, industry and other funds, in roughly equivalent proportions.

It is highly improbable that all of these multiple accounts are intentional.

We recommend that the Inquiry go further than it did in its Draft Report, and propose reforms to address existing multiple accounts.

We recommend automatic account consolidation whereby accounts which have been inactive for one year are automatically consolidated into the member's largest active account unless the member affirmatively decides to retain the inactive account.

Member communications to inform them of the auto consolidation must be neutral information only, not sales or solicitation material which seeks to encourage the member to keep the inactive account open.

2.1.3 A better solution to reducing the proliferation of multiple accounts

We recommend a different approach to address the proliferation of multiple accounts that that proposed in the Draft Report.

The Draft Report proposed that superannuation contributions would be made into the initial superannuation product a member joins. The danger with this proposal is that the initial product a person joins when they begin employment might not be ideal later in their career. As noted in Section 3.1.3 employees in different industries have different characteristics that are relevant to their offering.

We recommend that a member's entitlements automatically transfer to the member's new active fund when they change employment. If a member starts a second job, their contributions from the second job should be placed in their existing active fund.

This recommendation results in the same outcome as the Draft Report's proposal: members who enter the super system in the future will have one account unless they affirmatively choose to have more than one. However, it avoids the risk of members remaining in products that are no longer most suitable for them. It also protects members who might have originally been in a product offered by a for-profit provider from exploitation. The major banks and other for-profit super fund providers have a track record of leaving members in legacy products when doing so is profitable.[12]

2.2 Expand the protections of the default system to retirees, not just working members

There is consensus that superannuation should shift from a system focused on accumulation to a system focused on the delivery of retirement income.

In developing alternative models for allocating default members to products, the Inquiry should embrace this transition.

In countries with the best performing funded retirement income systems, the default product is always a whole-of-life income product designed to deliver retirement income, which begins making pension payments when the member elects to retire.

Adopting a similar approach in Australia would ensure that the protections of the default system would extend for as long as a member is connected to the superannuation system.

These protections are equally important – and perhaps more important – for older members. The Draft Report asserted that older members have less need for defaults because they tend to engage more with superannuation and because they tend to draw income streams at minimum drawdown rates: “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.”

But of course those observed behaviours do not support the point the Draft Report is trying to make because mere engagement and draw down behaviour does not indicate that retirees are better able to make <u>good</u> decisions in relation to super.

In fact, the evidence about financial decision making capability of older people, and the evidence about the financial performance of super fund members based on age, directly contradicts the Draft Report’s arguments.

- “Knowledge of basic concepts essential to effective financial choice declines after age 60. Financial literacy scores decline by about 2% each year after age 60, and the rate of decline does not increase with advanced age. Results from regressions censored by respondent groups and financial literacy topic areas suggest that the decline is not related to cohort effects or differences in gender or educational attainment.”[13]
- While capability declines, “confidence in financial decision making abilities does not decline with age.”[14]
- Even “large declines in cognition and financial literacy have little effect on an elderly individual’s confidence in their financial knowledge, and essentially no effect on their confidence in managing their finances.”[15]

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[12] See, Rainmaker Information, Research Note: Cost to retail fund members of delaying their MySuper transition, (October 2016) http://www.industrysuperaustralia.com/assets/MediaRelease/ISA-MySuper-transition-2016-final.pdf

[13] Finke et al. (2017), Old Age and the Decline in Financial Literacy, Management Science, 63(1), 2017, pp. 213-230.

[14] Id.

[15] Gamble et al. (2015), How Does Aging Affect Financial Decision Making?, Center for Retirement Research at Boston College, p. 4.

- Statistical analysis of the performance of older members who actively control their super investment shows that they actually underperform younger members: “From the full period analysis, using the natural log of investor age, younger investors earn more alpha than older investors. … [T]hose investors with age greater than 59 perform more poorly than the group with age less than 35 years. … In summary, investors age had little direct impact on the portfolio performance in the pre-GFC period though it took on greater importance for the post-GFC period with evidence that older investors tended to perform more poorly in a risk adjusted sense than the younger investors in the sample.”[16]

Insofar as long term net returns and service quality are important factors in the pension phase as well as the accumulation phase, extending the coverage of the default system to whole-of-life would only require modest changes to the selection criteria of the default system. In particular, the selection criteria should, in addition to long term net returns, relevant service quality, fees and costs, administrative efficiency, and other relevant factors, give consideration to the *efficiency of retirement income delivery*. For example, such efficiency may be greatest when the expected retirement income for life (weighted by probability of being alive) is highest per dollar of contribution by the member and government (via tax rebates or concessions).

2.3 Protect members who leave the default system

The greatest source of inefficiency in the superannuation system and member harm is the movement of members from high performing default funds into lower performing bank-owned retail funds and SMSFs.

No default system will address the inefficiency in the superannuation system or adequately protect members unless there are safeguards to ensure members who leave the default are better off.

There are two kinds of policies that can protect members from self-harm upon exiting the default system: policies that make it harder for providers to exploit members, and policies that ensure members have sufficient capability to exit the system.

We suggest the Inquiry give careful consideration to both kinds. Some options include:

(i) A *Better off test:* a requirement that providers do not provide advice or solicit a member acquisition unless the provider has reasonably determined that the member would be better off from a financial point of view;

(ii) An *Accredited member test,* which would assess the ability of a member to (a) withstand losses in superannuation with calling on the age pension, (b) understand relevant information, and (c) make relevant financial decisions. Recognising that members outside of the default system must constantly monitor their affairs in a dynamic environment, accreditation would need to be refreshed fairly regularly, and with increasing regularity after age 60; and

(iii) An *Earned profits requirement*, which would seek to better align the interests of fund members and providers. It would require a superannuation fund (or the average member of that fund) to achieve above-median net returns for a specified period before profits from the superannuation business of which the fund is a part to pay profits to the fund’s shareholders. In this way, shareholder profits would have been “earned” through outperformance.

[16] Gan, Heaney, and Gerrans (2014), Individual investor portfolio performance in retirement savings accounts, Australian Journal of Management, pp. 652-671

2.4 Ensure the superannuation system is not captured by the finance sector

The power of the financial services lobby is an area of study by the political science academy,[17] and by economists.[18]

Concerns about the power of the finance sector, and its culture and values, are quite widespread now.

This is an important issue for the Inquiry's effort to develop an alternative default fund selection model: how to ensure that it is not captured by the big banks and for-profit financial institutions.

It is particularly important because the power of the finance sector means that government alone cannot be relied upon to protect the public interest.

What is needed is a counterbalance, and this is indeed what is shown in the political science literature: the power of the finance sector is checked by organised interest groups with different objectives. In those OECD countries with high performing superannuation systems, this role is played by employers and trade unions. This is also the case in Australia's superannuation system, where employer associations and trade unions have performed this function for many years. On a cross-country basis, the most effective counterbalance has generally been trade unions.[19]

The participation of industrial parties is a key reason why the existing Australian default system has performed above the OECD average over the long term, and above the Australian average over the long term.

The participation of industrial parties (and related settings, such is not-for-profit institutions and strong policy regarding distribution) also are a key reason why the better funded retirement income systems in the world have outperformed.

2.5 Take stronger action to remove barriers to mergers

The Draft Report has asserted that a lack of consolidation in superannuation is a problem, and that a formal process for merger consideration combined with disclosure requirements in respect of all "merger approaches" "has merit."

We question the claim that scale is most important to net performance. There are many large for-profit funds that are in or around the bottom quartile of long term performance Figure 3, above).

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[17] See, e.g., Witko (2014), The Politics of Financialiazation in the United States 1949-2005, *British Journal of Political Science*.

See also, Tomaskovic-Devey and Lin (2011), Income Dynamics, Economic Rents, and the Financialization of the U.S. Economy, *American Sociological Review*.

See also, Keller and Kelly (2015) Partisan Politics, Financial Deregulation, and the New Gilded Age, *Political Research Quarterly*, pp 428-442.

[18] See, e.g., Igan, Mishra and Tressel (2012), A Fistful of Dollars: Lobbying and the Financial Crisis, *NBER Macroeconomics Annual*, University of Chicago Press, vol. 26(1), pages 195 – 230; See also Johnson (2009), The Quiet Coup, *The Atlantic*, May Edition.

[19] See, Witko (2014); see also, Hacker and Pierson (2010), *Winner-Take-All Politics: How Washington Made the Rich Richer – and Turned Its Back on the Middle Class*.

Findings about the significance of industrial parties as social institutions that shape society in potentially beneficial ways include, e.g.,: Korpi (2003), Welfare-State Regress in Western Europe: Politics, Institutions, Globalization and Europeanization, *Annual Review of Sociology*; *see also*, Rothstein, Samanni and Toerell (2012), Explaining the Welfare State: Power Resources vs. the Quality of Government, *European Political Science Review*.

Nonetheless, undertaking mergers and strategic combinations among funds could be easier than it is today. But the proposals in the Draft Report are unlikely to be helpful.

The Draft Report did not catalogue and assess the barriers to mergers, and did not examine the historical degree of consolidation, nor review how much more consolidation could reasonably have occurred (particularly given the instability of policy settings and other draws on fund resources).

As shown in Figure 4, above, the APRA-regulated superannuation sector has been consolidating at a notable rate.

The number of funds has declined by over 85% since 2004. The average size of APRA-regulated superannuation funds has increased over 20 times over the same period. The degree of consolidation is about even across retail and industry funds (45% and 57%, respectively), with higher rates of consolidation in the corporate fund sector (97%) and understandably lower rates among public sector funds (14%). This evidence, combined with growing emphasis by APRA on the scale of superannuation funds, raises a question of the degree to which this is an area of the superannuation system requiring substantial resource allocation by this Inquiry.

Nonetheless, efficiency gains could arise through greater consolidation in the interest of members.

The Inquiry's proposals in respect of mergers do not, however, address the real barriers, and could prove harmful.

In addition, while consolidation is happening in APRA-regulated superannuation, resulting in fewer funds and greater scale, the opposite is happening in the SMSF sector. The number of funds is proliferating, and the average size of new SMSFs is decreasing each year.

The Inquiry should carefully review the SMSF sector. We note that average SMSF net returns are lower than the average of APRA-regulated funds, and substantially below the average not-for-profit fund.

The Inquiry may wish to seek to make proposals addressing the lack of scale and the demonstrable inefficiency in the SMSF sector at some point.

Barriers to mergers of APRA-regulated funds

The successor fund transfers landscape is complex.

The legal obligations, duties and rights of trustees are multifaceted and are found both in statue and in general law (encompassing judge-made principles of both equity and common law). This platform, together with the specific requirements for successor fund transfers, creates a significant process that superannuation trustees need to undertake in deciding whether to merge.

There are protections afforded to members through the general law and statute, including the best interest test, the standard of care, skill and diligence requirements, the proper consideration requirements, the SIS regulations specifically dealing with the equivalent rights, as well as liability provisions.

Equivalent rights

Constraints on mergers imposed by the transfer rules include the complexities that trustees face in observing the requirement that members receive 'equivalent rights' in the proposed new fund.

The test necessitates both the incoming and outgoing trustee to determine there will be equivalent rights, and for the incoming trustee to actually confer equivalent rights (SIS regulation 1.03).

The scope of the concept of relevant 'rights' for the purposes of the equivalent rights test is unclear. Adopting a narrow view can expose trustees to liability, and members to harm. Trustees will therefore tend to take a prudent approach, and undertake a broader assessment of relevant rights, insofar as the scope of the requirements is unclear.

One way to facilitate mergers would be to resolve the uncertainty regarding what rights are relevant to the test, while ensuring member protection.

Statute and general law

In exercising decision making powers trustees have both statutory and general law duties and obligations that they must observe. For example, section 52(2)(b) of the SIS Act requires the trustee to exercise, in relation to all matters affecting the entity, the same degree of care, skill, and diligence as a prudent superannuation trustee would exercise in relation to an entity. This covenant, as well as a trustee's fiduciary duties under general law, leads some respected counsel to the view that trustees must consider a broader range of matters than just the requirements of the legislation with respect to successor fund transfers (equivalent rights).

Additionally, section 52(2)(c) of the SIS Act requires the trustee to perform the trustee's duties and exercise the trustee's powers in the best interests of the beneficiaries. The general law has a similar requirement.

Furthermore, the nature of direct liability also can lead directors to be cautious. Section 52A of the SIS Act indicates that a director of a superannuation trustee company can be personally liable for a breach of a director's covenant, including acting in the best interest of the members and exercising the care, skill and diligence.

Member protection

The legal landscape for trustees to navigate through in assessing the merits of a successor fund transfer is not straightforward and for this reason it ought not to be considered as a tick in the box exercise. The equivalent rights test objective is to protect members' as they are being transferred out, without consent, from their current fund to a new fund.

It is against this background, one must, consider the other barriers that exists.

Tax – CGT and stamp duty

The absence of on-going CGT rollover relief, as well as stamp-duty costs, creates a barrier to fund mergers.

The triggering of CGT events on a merger, such as the realisation of otherwise unrealised gains, and the inability to carry forward losses, may discourage a trustee from agreeing to a successor fund transfer.

In determining whether to merge with another fund, a trustee is under a legal obligation to act in the best interests of the members of the fund. Thus in deciding whether to merge the trustee will need to take into consideration the various benefits and costs to members of the potential merger, including tax consequences. In the absence of CGT rollover relief the costs to members, through the extinguishment of deferred tax assets, may outweigh the benefits of any proposed merger.

CGT roll-over relief should be permanently available to the industry to facilitate fund mergers and rationalisation to achieve economies of scale.

Additionally, funds that invest in real property also are subject to varying stamp duty requirements across different states. Determining the size and applicability of these taxes is expensive. These costs, combined with the payment of applicable duties, can be substantial and raise difficult questions about the fairness and efficiency of high up-front costs to consolidate in exchange for long term modest efficiency gains which may accrue to other members.

Risks of inherit liabilities from the "transferring out fund"

The incoming trustee must accept (and satisfy itself it has meet the SIS covenants) in accepting the risks associated with inheriting liabilities for the transferring out fund, including legal causes of actions, and tax liabilities.

Product level – legacy products

Notwithstanding the benefits of product innovation, various legal and regulatory barriers have often seen products forced to continue where it would be more efficient to rationalise them. For an individual fund, the existence of legacy products can be a barrier to a potential merger.

Costs

Commercial arrangements, particularly in respect of administration and platform technology, may include substantial termination costs and transfer costs. These can combine with tax and other transaction costs to cause seemingly “win-win” merger proposals to become much closer questions.

The Draft Report’s transparency proposals are unduly risky and unclear

Trustees currently have:

- A duty to give genuine consideration to the merger approaches; this duty is encompassed in the SIS covenants (section 52(2)b and 52(2)c),
- A duty to disclose material or significant events, this duty is encompassed in section 1017B of the Corporations Act.

The Draft Report’s proposal would require disclosure of all “merger approaches”, regardless of whether they were reasonable and potentially well before that could be assessed.

It makes disclosure able to be triggered unilaterally by a party – the proposed acquirer – that has no fiduciary duty to the target fund members, and may even have adverse interests to theirs. Handing the power to force disclosure about the merger approach to potential rivals and competitors seems unwise.[20]

Disclosure of the approach also could be premature and misleading. Due diligence inquiries and pre-merger discussions are important steps in the successor fund transfer process. The ability to share sensitive business information allows a trustee to assess the true likelihood of a successor fund transfer, and assess whether the target fund is in fact a good fit with its own. Yet, many approaches to merge do not result in a completed transaction (whether in superannuation or in the corporate world). If a merger fails due to commercial issues, or legal obstacles, it is not clear what is the benefit to members of disclosure of the merger approach?

Fund disclosure is an important communication tool between trustees and fund members for product comparison, but it is not clear what role it has in connection with evaluating merger approaches.

[20] Risks include creating an impression that the fund is “being shopped” or isn’t viable as a going concern, which could substantially impair the bargaining position of the fund.

3. The Inquiry's Proposed Alternative Models

3.1 Comments on certain common features of the models

3.1.1 Acute vulnerability to up-sell and cross-sell strategies

The Draft Report envisions a system where private sector, for-profit financial institutions can bid for and win pools of default superannuation members. Such an outcome will deliver to the for-profit part of the super system a ready-made, government sanctioned, customer base at a very low acquisition cost.

Once this customer base is acquired, these institutions will up-sell and cross-sell other products. Today, sophisticated members under professional advice enter into these products, and wind up poorer. Yet the proposal in the Draft Report would furnish for-profit institutions with customer base of less engaged default members, who are likely to be even more susceptible to being sold products that may not be in their interests (and leave them worse off overall).

Many banking products such as credit cards and insurance don't have any best interest duty attached. Many of these products are high margin (e.g., credit cards) and there is an unacceptably high risk that such institutions will seek to influence the selection process, as well as loss lead into the selection process, so they can obtain these customers to up-sell and cross-sell other products to their newly (and cheaply) won customer base.

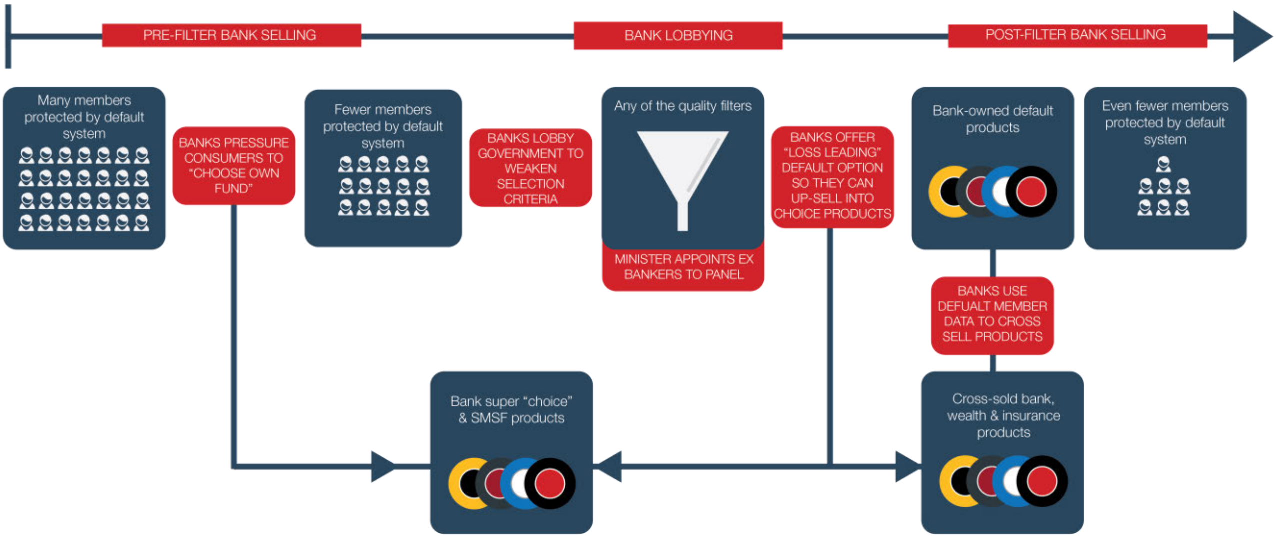
This commercial imperative (and reality) is one of the most acute risks in the Draft Report's proposals.

At a minimum, any model proposed by the Inquiry should expressly prohibit default fund trustees and their related parties from up-selling superannuation products, and cross-selling other products. These prohibitions will need to be backed by a very well-resourced compliance and enforcement effort, which would need to make periodic public reports on its endeavours.

However, the practicality of implementing such prohibitions and enforcing them is open to doubt. The commercial imperatives involved will result in an inexorable effort to erode the prohibitions. These efforts will begin during the legislative stage. If effective laws are enacted, they will be eroded mercilessly through "financial innovation" and regulatory arbitrage over time.

The Inquiry proposed no protections for consumers being sold products that transfer them out of the default safety net, nor did it consider how the banks' up-sell and cross-sell strategies would undermine each of the proposed selection processes.

Figure 6 – How the Draft Report proposals are vulnerable to the banks



Source: ISA

3.1.2 The selection panel

Composition

The concepts expressed in the Draft Report regarding the key principles of the selection body (pages 83-84) were generally appropriate, except for the inference that relevant interests – including employee and employer groups – should not be represented.

Inclusion of these parties is important to the political economy of superannuation, and maintaining a true member-oriented culture.

A weakness of the panel concept in the Draft Report is it becomes dominated by persons whose worldviews reflect those in the financial sector.

Independence

The Draft Report argues that accountability to (rather than independence from) a Minister is necessary to address the perception of "potential biases or conflicts of interest".

This argument is not compelling.

Accountability to a Minister means that an appointment can be removed at the discretion of the Minister without cause. This *adds* to the appearance of potential bias, in which an appointee could be perceived to be influenced by their involvement in the financial services industry, and their need to maintain the pleasure of the Minister.

Accountability (in respect of the tender and auction proposals)

It appears that the selection body for the assisted employee choice and assisted employer choice model would be a persistent entity, thus ensuring that there is some accountability for the decisions made: the panel or selection body that made good or poor choices would be able to be evaluated and scrutinised.

However, the selection body for the tender and auction proposal would phoenix periodically to perform the selection process, and then disband.

3.1.3 Lack of industry segmentation in defaults is a missed opportunity

Each of the proposed default models (and the assisted employee choice shortlist) are “undifferentiated” defaults, rather than industry-based defaults.

This is a missed opportunity for the proposed models. Superannuation addresses universal needs for security and decent living standards in retirement, indicating differentiation among members in terms of “product” is not necessary, and defaults and mandates are appropriate policy tools. However, there are significant demographic differences across industries that can assist in the provision and presentation of information and services (in addition the insurance and other mortality-related services).

Individuals have universal needs that are addressed by superannuation policy

Individuals have universal needs in respect of superannuation. Satisfying these needs is the foundation of the social policy objective of super, namely to deliver financial security and dignity in retirement through regular income that is, when combined with any public pension and other sources of income, sufficient to secure a comfortable standard of living by reasonable community standards.

This income in retirement needs to not just be “regular” but also to be reasonably predictable before retirement so that members can plan. It needs to be resilient in the face of financial volatility, and maintain purchasing power. A proportion of superannuation entitlements also need to be available for commutation to respond to lumpy contingent expenditures.[21]

Working people are relatively homogenous in terms of wealth and likelihood of age pension entitlement, which counsels in favour of default products with growth-oriented portfolios (not individually tailored portfolios based on risk preferences)

In addition, the Australian working population as a whole is reasonably homogenous from a financial point of view. As shown in Table 3, superannuation is the majority of wealth outside the family home for over two-thirds of the population. This percentage will increase with the rising Superannuation Guarantee. As shown in Table 4, among 55-64 year olds, superannuation makes up the majority of wealth outside the family home for all wealth deciles on average other than the top 10%, who have substantial other financial assets.

Table 3 – Super as a percentage of non-home wealth by age

	Super as percentage non-home wealth							
	81 to 100 %	**71 to 80%**	**61 to 70%**	**51 to 60%**	**41 to 50%**	**21 to 40%**	**Up to and including 20%**	**Nil**
Age								
65 to 74	38.60%	49.80%	55.50%	59.70%	65.60%	76.40%	90.50%	100%
55 to 64	49.60%	57.00%	64.30%	70.20%	74.30%	84.40%	95.30%	100%
45 to 54	55.20%	60.90%	65.00%	69.00%	74.20%	85.30%	96.80%	100%
35 to 44	54.80%	61.00%	65.90%	69.70%	74.20%	83.90%	96.30%	100%
25 to 34	50.10%	56.10%	60.20%	64.60%	68.90%	78.80%	95.10%	100%
All	52.20%	58.60%	63.50%	67.80%	72.40%	82.70%	95.80%	100%

Source: ISA analysis of the confidential unit record file of the ABS Survey of Income and Housing 2013-14.

[21] Unless these matters can be addressed through insurance paid out of ordinary income.

Table 4 – Assets by non-housing wealth deciles of persons aged 55-64

	Percentages (Mean)				
Non-housing wealth	**Super assets of person**	**Net Other Financial and Business assets of person**	**Net Value of other property of person**	**Total business and financial Assets**	**Value of net housing asset of person**
Decile1	100%	-118%	-162%	-181%	$119,825
Decile2	60%	61%	-20%	100%	$173,452
Decile3	66%	22%	11%	100%	$202,540
Decile4	63%	30%	7%	100%	$224,375
Decile5	64%	25%	11%	100%	$201,056
Decile6	61%	21%	18%	100%	$241,672
Decile7	59%	20%	21%	100%	$305,900
Decile8	51%	23%	26%	100%	$296,468
Decile9	58%	20%	22%	100%	$387,536
Decile 10	39%	35%	25%	100%	$504,708
All	48%	29%	23%	100%	$265,513

Source: ISA analysis of the confidential unit record file of the ABS Survey of Income and Housing 2013-14.

These and related factors[22] indicate there should not be major, if any, variance in investment strategies based on individual risk-appetites. Superannuation should be invested to maximise long term net returns, not to minimise the risk of adverse shocks or other changes to strategy designed to accommodate individual risk preferences. Wealth is highly skewed; it is concentrated in the top two deciles. Those people who might have significant wealth outside super and other resources are a small proportion of the population, and a smaller part of the working population. In addition, most working people are projected to be eligible for the age pension, which is a reasonably significant entitlement.

These two factors: limited wealth outside of superannuation and a means-tested age pension means that, from a portfolio construction point of view, super should be more growth oriented.

However, members of different industries do have different characteristics that are relevant to superannuation services other than investment management and benefit design

While there is a universal need for secure, stable and adequate retirement income, and the financial circumstances of working people indicate a portfolio that maximises long term net returns is appropriate, there are differences among the workers in different industries that are relevant to superannuation services.

- Mortality (which is relevant to life insurance and, in the future, pooled retirement income)
- Education, Age, Gender, and Income (which each can be relevant to communications, information presentation, community engagement, and similar services) (Education and Gender characteristics are set out in Table 5 to illustrate these differences by industry. In the Education and Training industry, for example, over 60% of employees have a bachelor degree or postgraduate qualification, whereas less than 15% have such qualifications in Agriculture, Forestry and Fishing. As another example, 88% of employees in the Mining industry are males, whereas 72% of Education and Training employees are females).

[22] Such as such as collective action and scale benefits.

- Propensity to experience unpaid super
- Tenure with specific employers

Table 5 – Educational characteristics of different industries

	Level of highest non-school qualification							Gender	
	Postgraduate Degree, Graduate Diploma/Graduate Certificate	Bachelor Degree	Advanced Diploma/Diploma	Certificate III/IV	Certificate I/II	Certificate not further defined	No non-school qualification	Male	Female
Industry of main job									
Agriculture, Forestry and Fishing	3.10%	9.30%	9.20%	18.70%	3.90%	1.70%	53.50%	66.60%	33.40%
Mining	6.80%	16.40%	6.80%	39.00%	1.00%	1.60%	28.30%	88.00%	12.00%
Electricity, Gas, Water and Waste Services	16.50%	15.50%	12.80%	27.90%	3.00%	2.00%	20.20%	74.90%	25.10%
Construction	1.20%	11.90%	7.90%	38.50%	1.40%	1.70%	36.70%	86.00%	14.00%
Accommodation and Food Services	3.10%	10.60%	9.70%	18.60%	3.40%	2.20%	52.20%	47.30%	52.70%
Financial and Insurance Services	19.20%	34.40%	14.10%	11.20%	1.80%	1.90%	16.90%	48.90%	51.10%
Education and Training	24.70%	35.90%	12.00%	11.10%	1.00%	1.70%	12.00%	28.10%	71.90%
Inadequately described							100.00%	100.00%	
All	10.10%	22.50%	11.70%	20.50%	1.90%	2.10%	30.30%	52.90%	47.10%

Source: ISA analysis of the confidential unit record file of the ABS Survey of Income and Housing 2013-14.

3.1.4 Each model ignores the effect of culture, and potentially promotes poor culture

The four models of default selection proposed in the Draft Report are silent on matters of culture: the set of norms and values that funds draw upon in practice when they decide how to act in relation to their members.

Culture is partly reflected in net returns to members. As we argued in our first submission, it is not accidental that, on average, not-for-profit funds outperform retail funds. Retail funds, owned by institutions whose primary concern is to maximise returns to shareholders, view members in revenue-maximising terms – not as people whose interests are to be served above all others.

Culture is also reflected in other aspects of fund operations. Retail funds have a history of using aggressive marketing to up-sell members from default products into poorer performing choice products. They have a history of using 'flipping' to move members from relatively low-cost employer-specific plans into higher-cost products when those members change employment. Retail funds also delayed transferring members of legacy accrued default amounts to MySuper products, which happened to be profitable for the providers, and harmful to the members.[23]

[23] See, Rainmaker Information, Research Note: Cost to retail fund members of delaying their MySuper transition, (October 2016) http://www.industrysuperaustralia.com/assets/MediaRelease/ISA-MySuper-transition-2016-final.pdf.

In short, the asymmetries between members and funds seem to be routinely used by retail funds to increase firm revenue.

The Draft Report appears to assume that the absence of a culture of service to others can be effectively compensated for by legislation and/or market design. This is not the case. Two examples help to illustrate why.

Firstly, in 2010 researchers at APRA examined the costs associated with outsourcing certain functions by for-profit and not-for-profit superannuation funds to related-parties. They reached the following conclusion:

"We find that 'relatedness' per se is not detrimental to fund members. However, when we consider whether the fund has been established on a not-for-profit basis, or as a retail commercial endeavour, we find that the trustees of retail funds pay significantly higher fees to related service providers. In contrast, the fees paid by trustees of not-for-profit funds to related parties are not significantly different than those to independent service providers."[24]

The authors then considered their findings in the context of the fact that trustees have a legal duty to act in the best interests of fund members. The question naturally arose: how can it be in the best interests of members that the trustees of retail funds elect to pay "significantly higher fees" to related providers, many of whom are part of the same financial services group? The authors ended their paper by stating:

"Reconciling this finding with the superannuation trustee's fiduciary duty to fund members will bear further investigation."[25]

Our view is that the finding cannot be reconciled with a fund's fiduciary duty.

The significance of this research is that it demonstrates that an obligation to act "in the best interests of members" has not in practice resulted in a uniform set of behaviours by all funds. Practices vary on the basis of how funds regard their members and what they then regard as appropriate behaviour. And it is when there is discretion about what is acceptable practice that culture matters. For-profit funds tend to take advantage of that discretion. Not-for-profit funds do not.

The models in the Draft Report will not be able to eliminate information asymmetry or discretion to take advantage of members.

Secondly, the Draft Report's apparent indifference to culture seems to reflect the view, widespread in some parts of the economics discipline, that how a good or service is provided does not change it. Whether it is provided by profit-maximising firm or a government organisation has no implications for what consumers receive.[26]

This notion has formed part of the intellectual framework that sees privatisation of some government services as a win-win-win for each of the taxpayer, the consumer, and the private firm. If the good or service delivered to the citizen/consumer remains constant, but it can be delivered in a more efficient manner, then the taxpayer saves money while the citizen/consumer either notices no difference or perhaps has improved service.

But in practice how a good or service is provided can have significant implications for what a citizen/consumer actually receives. This is clear from what happened when the Australian Federal

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[24] Liu, K. and B. Arnold (2010) *Australian superannuation outsourcing – fees, related parties and concentrated markets*, APRA Working Paper, p. 2.

[25] Id. p. 29.

[26] This view has been discussed and criticized by the moral philosopher Michael Sandel, among others, who has argued: 'On this assumption, money never corrupts, and market relations never crowd out non-market norms. If this is true, then the case for extending markets into every aspect of life is hard to resist. If a previously untraded good is made tradable, no harm is done…But this misses the corrosive effect of money." Sandel, M. (2012) *What Money Can't Buy: the moral limits of markets*, pp. 125, 122

government outsourced employment support services. Private contractors competed for access to a government created market for services that would provide support to those seeking work.

In theory, the contractors were expected to deliver services similar to those previously provided by government organisations, but more effectively because contractors were offered monetary incentives to secure particular outcomes.

In practice, because contractors operated on a for-profit basis, and viewed their unemployed clients primarily as a source of revenue, in many cases the quality of service declined compared to that previously provided directly by government. To reach targets, "difficult clients", such as the long-term unemployed, were given a low priority because they were regarded as too resource intensive. More attention was given to younger clients with recent employment histories. Clients in urban areas were prioritised over those in regional places. And so on. In some cases these poor outcomes were accompanied by fraudulent reporting of results and fraudulent claiming of expenses.[27]

The significance of the employment services debacle is that it shows what can happen when profit-maximising organisations enter into 'markets' where norms of service to others, care and impartiality should determine organisational behaviour.

This is particularly relevant to the present Inquiry because compulsory superannuation is not merely another product to be traded, akin to mobile phones or personal computers. Compulsory superannuation is an aspect of social policy, implemented to help increase the eventual retirement incomes of all those that are required by law to make contributions. In this context, who provides superannuation, and how they regard members, matters.

It is also instructive that the effort to create competition "for the market" in respect of employment support services did not secure the public service outcomes that were anticipated by theorists.

It is therefore important that the Inquiry recognises the importance of culture, and how it varies, across the superannuation industry. It would be ironic that just as governments and regulators around the world are coming to recognise the significance of culture to understanding the behaviour of financial firms, this Inquiry appeals to law and markets as reasons to ignore it in the context of our superannuation system.

There are some policy options the Inquiry could consider recommending that recognise the importance of culture in superannuation and so better protect default members who are at risk through no fault of their own to being harmed by disloyal providers. These include:

- An *Earned profits requirement*, which would seek to better align the interests of fund members and providers. It would require a superannuation fund (or the average member of that fund) to achieve above-median net returns for a specified period before profits from the superannuation business of which the fund is a part to pay profits to the fund's shareholders. In this way, shareholder profits would have been "earned" through outperformance.
- Insisting that all for-profit funds with default members fully and publically disclose the quantum and sources of profit that they make from those members on an annual basis.

3.1.5 Vulnerability to financial sector influence

The banking sector's influence

Much of the existing scholarship that has sought to estimate the influence that banking exerts on politics and public policy outcomes relates to the USA and, to a lesser extent, the UK. To date, there appears to have been little analogous research in an Australian context.

[27] Whelan, J. (2012) *Big Society and Australia*, Centre for Policy Development, Sydney.

The lack of academic research on this topic has been accompanied by a lack of transparency in relation to exactly who makes political donations, or how much, and to what effect. In the view of Dr Lindy Edwards at UNSW, "Our political donations disclosure regime is so opaque that we don't really know who is paying how much and what they get in return."[28]

However, given that banking has been shown to be highly active, and often highly effective, in the USA and elsewhere – in large part because it is a large, highly profitable industry that is very sensitive to public regulation – it is reasonable to assume that banking in Australia has similar motives and interests in the sphere of public policy.

Since the 1980s banking in Australia, as a share of all financial services, has grown from 50 per cent to 90 per cent. The share of banking held by the 'big four' banks, who dominate the market in for-profit superannuation products, has grown from 66 per cent to 83 per cent over the same period. And as banking in Australia has become the most concentrated banking sector in the world, the big four banks have been four of the eight most profitable.[29]

One indicator of how banking has sought to protect and advance its interests is provided by disclosures of political donations. In 2015-16, political donations to political parties by the financial sector amounted to $2.7 million, second only to the $3.5 million donated by the property and construction industry – with which banking has a very close relationship.[30]

The similarities of the UK and USA to Australia in terms of their democratic structures and interest-group formation, along with the level of political donation by the finance sector, support an inference of influence.

But as a large and profitable industry with the resources needed to sustain a high level of lobbying, donations are not the only way banks seek to shape public policy. As in other countries, banks in Australia help to fund academic and commercial research into financial markets, alongside conferences, seminars, scholarships and related publications – all of which contribute to intellectual capture, and dissemination of a favourable worldview and set of priorities.

These efforts are often bolstered by a commercial print and broadcast media that competes for the considerable advertising spend that the large retail banks deploy every year.

3.1.6 Removal of the right for workers to bargain for a default fund

The alternative models proposed in the Draft Report would not allow workers to collectively choose their workplace default fund through industrial agreement.

This would strip workers of important industrial and workplace rights. Superannuation is an employment-related entitlement, being a component of remuneration. As noted in the Draft Report, superannuation became an industrial matter in national wage bargaining in the 1980s. Workers traded up-front wage increases for deferred wages at retirement. Aside from the intrinsic character of superannuation as deferred wages, it is well-settled that superannuation is a condition of employment that is, as with other

[28] Edwards, L. 2016) 'What do businesses get in return for their political donations?', *The Conversation*.

[29] International Monetary Fund (2012), Australia: Financial System Stability Assessment, *IMF Country Report No 12/308*, Appendix 2.

[30] These figures are from AEC disclosures, subsequently classified by industry by the ABC: http://www.abc.net.au/news/2017-02-09/political-donations-industry-dataset/8229192

conditions, routinely subject to collective bargaining both with regards to contribution rates and default fund selection.

As indicated above in Section 3.1.3, industries can vary (as can workplaces), resulting in certain characteristics of the offering of funds – ranging from compliance to communications to insurance – to be highly relevant, and therefor important in bargaining.

Moreover, performance differences between funds mean that both contribution rates and fund selection will determine the value of workers' deferred wages when they reach retirement. Preserving the right for workers to bargain collectively on both of these elements is fundamental.

3.1.7 ATO

The ATO is a critical public institution, performing a central role in the collection of government revenue. It may need to change substantially to perform competently the prominent role in superannuation that is sketched out in the Draft Report, not just in terms of operations and resources, but also organisational priorities. Such substantial changes to the ATO could be both risky and costly, while the benefits of doing so are not always clear.

Background: The ATO's priorities, role in the public sector, and its competence in superannuation related matters

The ATO is the core public institution responsible for the vital function of collecting federal revenue.

While some public institutions are structurally designed to be independent of Government, the ATO is typically very responsive to the policy intentions of Government.

These factors have affected the manner in which the ATO has performed its role in superannuation over the years.

While the ATO has understandably prioritised revenue collection activities, reviews of its superannuation responsibilities suggest that these matters have received a lower priority and lower resourcing.[31] It is suggested that it may have affected the execution of these responsibilities.

In its 2015 audit of the ATO,[32] the Australian National Audit Office (ANAO) found that the Superannuation Guarantee scheme has been operating largely without ATO intervention.[33] This was despite the ATO's own findings that non-payment of super is "endemic" in certain industries where employees are likely to have a significant need for super to supplement the aged pension.[34] ANAO observations and concerns about the ATO's approach to superannuation included a number of factors that suggest pushing the ATO to take on more responsibility in superannuation may not be desirable:

- In connection with undertaking its superannuation responsibilities, the ATO has in some instances placed excess emphasis on electronic information systems and data collection. This has come at the cost of field investigations, resulting in overreliance on employer reporting and low levels of employee notifications. Focusing on electronic information systems and data collection contributed to the ATO's conclusion that "overall, employers continue to demonstrate high levels of compliance" with the SG Act.

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[31] Australian National Audit Office, *Promoting Compliance with Superannuation Guarantee Obligations*, Performance Audit No 39 (2015).

[32] Id.

[33] Id. at 18.

[34] ANAO report 17-18. The report identified small and micro businesses and industries with large numbers of cash transactions as key problem areas for unpaid SG.

- The ATO's prioritisation of superannuation matters may have contributed to the instances in which the ATO has not pursued unpaid super in employer insolvency proceedings, despite employee notice, and the slow responsiveness to employee notifications of non-payment, notwithstanding that this is a situation where time is of the essence given the high correlation between non-payment of SG and employer insolvency.
- An greater attention to behavioural risks and individual experience of superannuation could have aided the ATO review of SG compliance. General SG compliance was assessed by testing whether overall employer contributions exceed the statutory percentage of salary and wages paid. A better methodology might have taken into account that some employers pay higher than legislated levels of SG, while others pay less or make no contributions, and that some employers pay no SG at all;[35] and a lower reliance on employee notifications regarding unpaid super insofar as employees are "reluctant to complain to the ATO about unpaid SG".[36]
- The ATO's relatively low capacity to prioritise superannuation matters has been illustrated by (i) the instanced in which the ATO has not pursued unpaid super in employer insolvency proceedings, despite employee notice, and (ii) the ATO's responsiveness to employee notifications, which have too often been slow notwithstanding that this is a situation where time is of the essence given the high correlation between non-payment of SG and employer insolvency.

The ATO is considered to be quite responsive to the policy intentions of the government in its application of resources and approach to program implementation. In recent times, this may have led the ATO to design single touch payroll systems which will collect an employer's 'SG liability' for an employee rather than collecting ordinary time earnings (OTE) as required by legislation. OTE is necessary to determine whether SG entitlements have been paid, and is necessary for the evaluation of the correct level of SG payment. It is suggested that not measuring the SG base raises a question about the commitment to superannuation and policy enforcement.

The ATO development of a superannuation clearinghouse

The Draft Report proposed that the ATO could develop a clearinghouse for SG payment.

This proposal seems unnecessary insofar as there are several private clearinghouses that have already been established under SuperStream.

Superstream has been hailed as a success by commentators and employers alike.[37]

However, unless there is a market failure with these systems – which has not been suggested – the establishment of a new, centralised ATO clearinghouse would seem only to add an unnecessary layer of bureaucracy and duplication, and would be wasteful given the significant investment by a number of institutions in SuperStream.

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[35] ANAO report 20-21, 49-51.

[36] ANAO report, 21; Anderson H and Hardy T, 'Who should be the super police? Detection and recovery of unremitted superannuation', *UNSW Law Journal*, vol 71(1) 2014 168.

[37] Philip Hind, 'Get Ready for SuperStream' *Sydney Morning Herald*, 19 April 2015, < http://www.smh.com.au/small-business/finance/get-ready-for-superstream-20150419-1mo60o.html>.

"We are starting to see the early signs of success from employers who have already adopted SuperStream. While visiting Bathurst last month, a local bookkeeper told me how making super contributions would normally take half a day. But, since putting SuperStream in place, it now only takes him 10 minutes."

Further, having a centralised clearinghouse could cause delays in handling of contributions. It also may be tempting to develop an ATO holding account, which could be a potential source of government revenue (and impair member net returns).

Lastly, prior experience with ATO capability to maintain prioritisation of superannuation matters could raise a question regarding the long term prospects if such a clearinghouse were built (particularly if it were not a priority in the future for government relative to other matters).

It would be appropriate for the data arising from SuperStream to be centrally collected, but this does not require a new ATO clearinghouse.

Extension of the myGov platform

The ATO's responsiveness to the policy intent of Government has been instrumental in the development so far of the Office's online system to facilitate superannuation fund choice.

So far, the focus of development has been on presenting products for members to choose, not information that demonstrably results in them making a good choice, nor the development of a decision architecture that assists members to connect with funds that have passed a quality filter, primarily the employer's default.

A potential benefit of the myGov endeavour is the ability to consolidate accounts. However, it is hoped that appropriate policy will be enacted, resulting in the prevalence and proliferation of multiple accounts to no longer be an issue. When that happens, the myGov portal could be mainly duplicative of the private administrative platforms of funds.

Lastly, the myGov platform, because it is member facing, could be a major challenge for the ATO – perhaps to a greater degree than matters relating to non-payment of SG. Effective implementation of the myGov platform will require a substantial allocation of resources over time, and a very high level of care to ensure good member choices, not just the promotion of super product choice. Implementation of an effective member-facing platform is not primarily a technological challenge, but a communication, engagement, and design challenge. The experience with unpaid super, where insufficient attention was given to the behavioural risks arising from monitoring for compliance based on employee notices, highlights the risk. Yet the myGov endeavour is potentially a greater challenge because the system will need to furnish useful, comparable and digestible information to facilitate member decisions using the platform. A platform that had the effect of placing members into underperforming products would be bad outcome for members, and – because it was designed and operated by the ATO to implement the policy intent of the government – reflect poorly on the ATO and the responsible government.

3.2 The Auction and Multi-Criteria Tender Models

The Draft Report discusses two models for default selection that would involve winning funds entering into contracts with the Federal government to provide products and services to new default members.

The "fee-based auction" model would decide selection based primarily on fees, while the "multi-criteria tender" model would involve evaluating participating funds on the basis of a broader range of criteria.

We outline each in turn before discussing significant problems common to both.

3.2.1 The fee-based auction

Under this proposed model, superannuation funds would compete for default status by out-bidding on member fees. Such fees would comprise a measure of administration and investment fees on the basis that they "should account for a large proportion of the total charges levied on members".

The Draft Report argues that a focus on fees as the bidding metric is justified because it is reasonable to presume that member fees explain significant variations in net returns overtime.

The role of the auctioneer, as the body responsible for conducting and deciding the outcome of the auction, would "be independent and free of any interests in the participating funds." However, because the decision to select winners "is a function of a single, objective metric", it is suggested that the precise status and membership of the responsible body is less critical than it is in contexts where more complex and subjective assessments are required.

The Draft Report argues that "a first-price sealed bid auction is likely to be the best fit" partly on the basis that the sealed nature of the process allows for a best-and-final offer stage that could be used to produce multiple winners. This stage means "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 Draft Report asserts that the combination of sealed-bids in the context of multiple winners would encourage participation and help generate downward pressure on the winning metric.

Default members would be allocated to each winning fund on a sequential basis.

Winning funds would enter into a contractual relationship with the Federal government, with contracts monitored via ongoing communication and disclosure, accompanied by Ministerial responsibility for enforcement.

The possibility that agreed fees would be increased during the life of a contract because of a merger between a winning fund and a non-winning fund "would be collectively addressed by the contract and current regulatory measures".

A winning fund that loses a future auction "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". These members would be offered "some protection" by "existing regulatory measures" and the publication of subsequent auction results.

The Draft Report acknowledges a number of problems and risks that may be generated by a focus on fees. In particular, the Draft Report discusses the risk that too great an emphasis on low fees may result in unsustainable loss-leading bids, a deterioration in service quality, and a preference for passive asset allocations.

In response, the Draft Report argues that a pre-qualification stage would test for the resilience of bidding funds and their capacity to offer minimum levels of service quality.

A further risk noted in the Draft Report concerns enforcing the contracts: "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 such disputes can be dealt with "by maximising transparency subject to commercial considerations".

The Draft Report concludes that a sealed-bid fee-based action, supported by contractual transparency and a pre-qualification stage, "would promote long-term net returns, despite the potential for it to push funds away from particular higher cost asset classes".

3.2.2 The multi-criteria tender

The multi-criteria tender discussed in the Draft Report has many features in common with the fee-based auction:

- There would be a pre-qualification stage to determine the capacity of funds to manage default flows and provide products and services of a minimum quantity and quality.

- There would be multiple winning funds with members allocated on a sequential basis.
- The terms of appointment would be specified in a Government contract.
- Members of funds that lose a future tender would not be automatically moved into a new winning fund.

The key difference between the two is that the final selection stage, following pre-qualification, would involve assessment on the basis of multiple criteria, “weighted by their relative importance”. The Draft Report suggests criteria headed by “past performance on net returns and independent surveys of member satisfaction”, followed by “investment strategy and governance”, “quality of member services”, “fee levels and transparency” and “innovation in other areas”.

One advantage of this approach over the fee-based auction, the Report argues, is that “a tender could…help to address the risk of lower investment diversification under a fee-based auction”.

The Draft also acknowledges several risks that are likely to accompany the application of a multi-criteria tender. In particular, it is suggested that the complex and subjective nature of a process based on multiple criteria, some of which will be applied to aspects of performance, governance and service provision that may be difficult to quantify in a consistent manner, may bring the tender process and results into disrepute. However, the Draft Report indicated these risks must be weighed against the advantages that the model may deliver: “…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.”

3.2.3 Comments on these proposals

Neither model is good public policy for default selection.

The discussion of the two models contained in the Draft Report acknowledges several risks attached to both, but downplays the potential significance of these risks while failing to acknowledge others.

The key problems with proposals include:

- A tender or auction based on administrative and investment costs will fail to capture many of the current ways in which value is extracted from members and would see default products by for-profit providers shift the way in which they extract value from members into other arrangements.
- The proposals fail to give regard to political risk, a fatal flaw according auction to design experts.
- The proposals fail to give regard to capture by industry (in this case, the finance sector), a similarly critical flaw.
- Empirical analysis of government capacity to monitor for contractual compliance and enforce it, suggest this is a far greater challenge than the Draft Report acknowledges.
- The proposals fail to protect members when a product loses default status. This failure is a necessary outgrowth of the design and it will be easy for providers to game.
- The auction and tender proposal could undermine the ability to invest using an optimal asset allocation, particularly in respect of illiquids. This could affect not only long term net returns, but also the Australian economy.
- Superannuation differs substantially from an ideal subject for an auction or tender process.
- The “best-and-final” offer stage could undermine the motivation of participants to compete in the auction and tender.

- The auction and tender proposals seek to harness – and therefore rest upon – selfish motivations of providers, and signal that the cultural norms in the financial services sector are appropriate in the social policy arena of superannuation.
- The auction and tender proposals dehumanize people, reducing them to a slab of "default members" to be allocated sequentially to massive institutions.

Costs other than investment and administration exist, and could be increased substantially

There are many ways in which the finance sector makes money, and some of them are designed not to be fees or appear to be fees.

A tender or auction based on administrative and investment costs will fail to capture many of the current ways in which value is extracted from members. A tender or auction based on administrative and investment fees would almost certainly see default products by for-profit providers shift the way in which they extract value from members into other arrangements that eat away at net returns but do not involve a direct payment to a third party.

Obvious examples include buy-sell spreads and other transactional costs.

It is difficult to see how a tender or auction based on anything other than net returns and that excludes for-profit providers could keep pace with "financial innovation" to achieve regulatory arbitrage.

Political risk and regulatory capture

In common with the other proposed models, the effectiveness and robustness of the auction and tender selection processes depends to a significant degree on the composition and standing of the selection body. There are a number of problems with how the Draft Report discusses the likely risks attached to this body and how it may operate in practice.

The Draft Report suggests that independence of "the responsible body" from participating funds is less important in an auction context than in other contexts, such as a multi-criteria tender, because the bidding metric is a single and objective measure. However, critical parts of the model involve substantial discretion.

- The model includes a pre-qualification stage, which determines which funds and products are even eligible to tender.
- The determination to allow some funds to match winning bidders.
- Contract monitoring and enforcement.

An effective evaluation of fund structures and capacities is likely to be a complex process, characterized by significant information-asymmetries between funds and the body. It will likely require the evaluation of complex business system information and projections which will, in practice, involve a considerable degree of subjective judgment and estimation. Much will turn on the quality, quantity and trustworthiness of the data that funds are willing to give the independent body access to, and the willingness of that body to challenge and interrogate what it is told.

In this context the composition, incentives, and structure of the body, and its capacity to make complex judgements, will be very important. Maintaining effective independence from the self-interest of parts of the industry, while having the ability to question and challenge the information that is provided during the pre-qualification stage, is unlikely to be straightforward and uncontentious process. This will be even more so in a multi-criteria tender context.

The risk that the responsible body, charged with a very public responsibility to conduct a process that is seen to result in a number of diverse funds being awarded contracts, may adopt a 'flexible' approach to how it applies pre-qualification criteria cannot be discounted.

This potential problem touches on an important aspect of the models that the Report ignores: political risk.

The Draft Report notes that auction and tender models are used by governments around the world to sell and allocate a range of public assets and services. However, the Draft Report does not acknowledge an important aspect of this experience: the conduct and outcomes of auctions and tenders is often of political importance to governments and of considerable economic importance to the private companies that take part.

In short, the design, conduct and outcome of auctions and tenders can be an intensely political and contested process, subject to lobbying, political negotiation and compromise. Where significant amounts of political and private capital are at stake, the elegant logics of the auction and tendering models designed in the ivory tower may not be those that are applied in practice.

In a review of the real-world application of auction models in across a number of countries, Klemperer (2004) noted a pervasive tendency among those who design auctions and recommend them to government to ignore the risk that small but significant changes to design made under political and commercial pressure can lead to unexpected and costly outcomes. In particular, the desire by elected governments to be associated with auctions that are successful in terms of participation levels and gaining support from industry leaders has often made them willing to adjust selection criteria, such as reducing reserve prices.

Klemperer, an economist who specializes in auction design and has acted as an advisor to several European governments on auction implementation, argues:

> When economics is applied to policy, proposals need to be robust to the political context in which they are intended to operate. Too many economists excuse their practical failure by saying 'the politicians (or bureaucrats) didn't do exactly what I recommended.' Just as medical practitioners must allow for the fact that their patients may not take all the pills they prescribe, or follow all the advice they are given, so economics practitioners need to foresee political and administrative pressures and make their plans robust to changes that politicians, bureaucrats, and lobbyists are likely to impose.[38]

Klemperer concludes that political risk must be an explicit consideration in auction design. This is particularly relevant to auctions and tenders that take place in the context of financial services. The financial services industries in developed economies possess a number of characteristics that make them powerful lobbyists and political players:

- Their profitability is often highly sensitive to public policy and regulation, providing them with a strong incentive to attempt to shape laws and regulations in their favor.
- The financial sector is often dominated by a small number of very large and wealthy corporations with the resources to engage in extensive and sustained political activity.
- The complexity of financial products, institutions and markets can cultivate significant information asymetries between the industry on the one hand, and politicians and regulators on the other. This can make industry claims that certain policies will disadvantage consumers and broader economic growth difficult to assess and refute.[39]

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[38] Klemperer, P. (2004) *Auctions: theory and practice*, Princeton University Press, p. 124.

[39] Hardy, D.C. (2006) *Regulatory Capture in Banking*, IMF Working Paper WP/06/34, Washington

Since the 1970s, the banking and financial services industry has proven to be highly effective in shaping public policy in its interests and collapsing the distinction between the public interest and that of the financial sector. This has involved two complementary forms of capture:

- A regulatory capture in which formally independent regulators were reluctant to challenge the business models and practices of many of the world's largest financial institutions.
- A broader intellectual capture in which the world-view of finance, premised on the assertion that an ever larger and more profitable financial sector is coterminous with the interests of the public, has become widely accepted in government, academia and the media.[40]

Regulatory and intellectual capture are strong reasons to doubt that securing the effective and ongoing independence of a body tasked with selecting or filtering appropriate default products will be as straightforward as the Draft Report appears to assume.

While the Draft Report discusses various mechanisms for establishing formal independence from the superannuation industry and, to a lesser extent, from the government, the Draft does not discuss the risk that those who are appointed to make selection decisions within formally independent institutions may bring with them an economic worldview and sensitivity to commercial priorities which mean their decisions favor some approaches to design and selection over others.

Clive Briault, former Senior Regulator at the UK Financial Services Authority and Bank of England, offered the following reflections on his time as an independent decision-maker:

> "Regulation and supervision operate in a political, social and cultural context. This includes the prevailing political ideology - which might be generally in favor of free markets, or alternatively in favor of state intervention or even state ownership - and the attitude of the government to regulation - which might be to regard regulation as red tape and needless bureaucracy, or it might be in favor of more and tougher regulation. Even if a supervisory agency is 'independent' in the sense of enjoying strong statutory protection from interference, it is likely to be influenced by the political climate."[41]

Formal and demonstrable material independence from particular superannuation funds and the institutions that own some of them does not necessarily mean that those involved in making fund selection decisions will reach decisions that are in the best interests of default members. A person does not have to be employed by a bank to approach the matter of default selection with the assumption that the more funds that are listed or selected the better, or that individuals should bear ultimate responsibility for their choices. These are normative assumptions embedded in worldviews that transcend formal material independence from particular commercial interests.

In practice, these assumptions could mean ignoring certain indirect fees and costs, allowing as much bid matching as possible, or lowering the standards applied during an auction pre-qualification stage as much as possible. Gaming behavior is impossible to predict.

While the scope for discretion in such areas may be limited by law and regulation, such limitations are ultimately politically determined by Ministers and those who are most effective in agitating their business interests. To the extent that securing new default business is viewed as important to the revenue-maximizing business models of for-profit superannuation funds and the banks that own them, any regulatory limitations that disadvantage their commercial interests are likely to be subject to continuous lobbying and pressure for change.

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[40] Baker, A. (2010) 'Restraining regulatory capture? Anglo-America, crisis politics and trajectories of change in global financial governance', *International Affairs*, Vol. 86, No. 3.

[41] Briault, C. (2012) 'Regulatory Capture, Political Dominance or Collective Intellectual Failure? A View from a former UK regulator', in Pagliari, S. (ed.) *Making Good Financial Regulation: towards a policy response to regulatory capture*, Grosvenor House Publishing.

A great strength of the current default process is that decisions about default selection for the purposes of enterprise bargaining and award determination are made in contexts (workplaces and the Fair Work Commission) that are institutionally and ideologically detached from the financial sector. Indeed, this detachment is a key reason why banks and retail funds have been agitating over many years for default selection to be removed from the industrial relations system and placed in the hands of employers with whom they have already existing business relationships that can be leveraged in an attempt to influence default selection.

Contractual monitoring and enforcement

Politics and influence are also relevant to the question of contract enforcement. But additional challenges, including resourcing, also call into question the Draft Report's proposals.

While the Draft Report touches on these issues, the discussion is brief and suggests that problems of compliance and enforcement can be largely mitigated by transparency.

This is simply incorrect. Transparency is necessary, but not sufficient. There is substantial real world experience with the kind of contracting envisioned by the Draft Report which illustrates this.

Both models establish contractual relations between funds and the Federal government, with Ministers ultimately responsible for enforcement. The Draft Report does not systematically discuss the risks and problems that real-world experience of reaching, operating and enforcing such contracts can entail.

In the UK, the use of complex tendering arrangements to provide public services has been more widespread than in Australia over the past 30 years. There is also a more substantial body of independent research into the problems that such arrangements can entail generated, by among others, the National Audit Office and the Institute for Government.[42]

While the contracts reviewed in this research do not relate to auctioning or tendering by government for retirement-related products and services, the issues identified do speak to the general, long-standing and recurring problems that the UK government has experienced when trying to reach and enforce contracts with for-profit providers that are in the public interest. These problems include:

- Firms resist competing for government contracts on an open-book basis. Firms argue that requiring such transparency undermines their commercial interests, not just with government, but other non-government organizations they seek to contract with. On the government side, there is a persistent reluctance to insist on open-book clauses because of concern that doing so may inhibit firms from competing for contracts.
- Contract managers often do not enforce penalties for poor performance. In part this is because they did not want to undermine good relations with the contractor, or signal to Ministers and the media that a contract was failing. Furthermore, there was a concern that seeking to impose penalties in relation to ambiguous or subjective criteria may provoke expensive and time consuming disputes. In some cases it was also judged that the penalty costs would be passed-on to customers and so imposing them would be unlikely to change a firm's behavior.
- A reluctance by firms to provide sufficient information to government that would enable effective contract monitoring and enforcement, and a reluctance by government to insist on such information

[42] The discussion here draws from the research and conclusions presented in: The House of Commons Public Accounts Committee (2009) *Central government's management of service contracts, Seventeenth Report of Session 2008-09*, London; The Institute for Government (2013) *Making Public Sector Markets Work*, London; National Audit Office (2014) *Transforming Government's Contract Management*, London.

because it lacked the skills and resources to make effective use of it. This resulted in an excessive reliance by government on the accuracy of data provided by the contractor.

- Once contracts were agreed, many government departments did not have the resources to effectively police and enforce them. Meaningful monitoring of on-going contracts became a low priority in the context of departmental competition for scarce resources.
- Persistent and widespread gaming of contract performance metrics by focusing on those customers who were quick and easy to serve, and estimating that minor breaches of certain low-profile performance targets would not be penalized.

In sum, while the UK government has recognized the importance of transparency to entering into contracts with for-profit contractors, a reluctance by many firms to compete on such a basis, combined with a political imperative to be seen to be conducting successful tenders and contract negotiations, has meant making progress on this issue has been very slow.

In 2014 the National Audit Office (NAO) concluded that despite over 30 years' experience of extensive contracting across government, the problem of lack of sufficient transparency remained. This was contributing to what the NAO labelled a 'crisis of confidence' in government contracting with private providers.[43]

The Draft Report acknowledges the importance of transparency but seems to assume that once acknowledged it is relatively straightforward to realize it in practice. The UK experience suggests otherwise. But without funds agreeing to high standards of verifiable transparency and information exchange which enables government to routinely determine that all the performance metrics of an agreed contract are being met, there can be little public confidence that default funds decided by auction or tender are operating in ways that are fully aligned with the interests of default members.

The UK experience suggests that the information-asymmetries that inevitably characterize relations between government and external providers are not easily overcome: they require a degree of resourcing by government, political will and co-operation from firms that is easy to assume but has proven difficult to realize in practice.

The auction or tender model could impair long term net returns and the economy by undermining the ability to invest optimally

The Draft Report acknowledges that the proposed fee-based auction "could increase incentives for funds to adopt a low cost passive approach to investment"; and could cause funds to "avoid or limit exposure to higher cost asset classes (such as illiquid investment opportunities like infrastructure and unlisted property".

However, the Draft Report downplays these effects, suggesting limited benefits of portfolios that include illiquids (i.e., diversification), and suggesting that "In the end, putting young disengaged members in a low cost, passive growth investment may not be an unreasonable approach".[44]

We disagree for the following reasons:

- First, the Draft Report seems to have misinterpreted the academic article by Cummings and Ellis (2015). The Draft Report quotes this article saying "'taking account of risk, there is no evidence of outperformance for funds with higher allocation to these [illiquid] investments". However, the meaning of "outperformance" in the context of that sentence is "alpha" – that is, whether the investors

[43] National Audit Office (2014)

[44] A similar deleterious effect on illiquid investment could also occur under the multi-criteria tender due to intellectual capture.

"outperformed" the indices specified by the researchers.[45] The paper did not dispute that inclusion of illiquids such as infrastructure support a superior risk-adjusted portfolio compared to a portfolio with only listed assets. In addition, the methodology used to detect alpha in connection with unlisted infrastructure and unlisted property is questionable: the universe of investments that make up the benchmark indices for unlisted assets in the paper might be substantially owned by the superannuation funds whose "alpha" would be shown by the outperformance of the indices. A cursory examination of the components of the unlisted property index used in the paper, compared to the investment holdings of Industry SuperFunds shows substantial overlap.[46] Put another way, it is not clear that the methodology in the paper could demonstrate the presence of "alpha" since the benchmark performance is the investors' own investments: showing "alpha" would involve a relatively small group of super funds outperforming themselves. We stress, however, that "alpha" should not be the emphasis when assessing whether illiquids such as infrastructure should be a significant part of the portfolio allocation of the superannuation system: enormous member benefit can be generated through "beta" via an optimal asset allocation, even if there is no "alpha".

- The long term net returns of portfolios including illiquids such as infrastructure have clearly outperformed portfolios without these assets, consistent with the expectation that they improve the risk-return profile of a portfolio.
- Reviewing the relative risk-adjusted performance of different asset classes over time demonstrates why this is the case (Figure 7). Over the past 15 years, together with international fixed income, unlisted infrastructure has been a consistent performer. All other asset classes have suffered from periods where they underperformed cash.

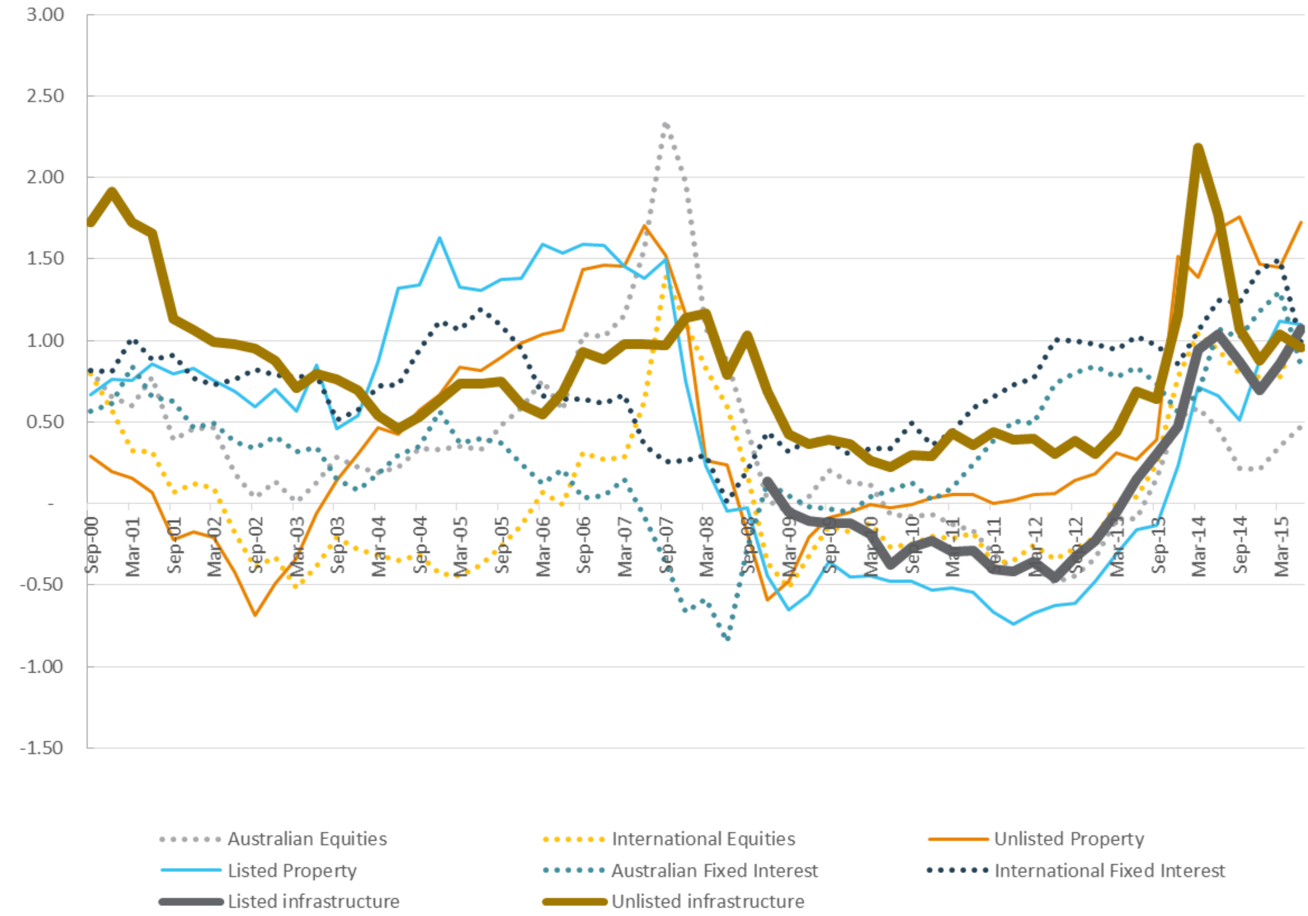
[45] The paper explained its methodology, and makes clear it is referring to alpha: "Controlling for the variations in exposure to the asset-class factor risks, there is no significant difference in portfolio alphas between funds in the first and third tertiles for their allocations to illiquid investments."

[46] The indices used were:

1. For unlisted property, the Mercer/IPD Australian Pooled Property Fund Index, which includes a number of investment pools the weighted owners of which would be the same super funds that invest in illiquid assets. It is not clear how the Mercer/IPD Australian Pooled Property Fund Index is constructed and weighted, but we compared the "core funds" in the index with some of the holdings of Industry SuperFunds and found substantial overlap. This is no surprise, given the index's core funds include three ISPT funds, two QIC funds, two GPT funds, Dexus, and three AMP funds.

2. For private equity, the Cambridge Associates Australia Private Equity and Venture Capital Index (CA). We have not sought to review the elements of the CA index and compare it to the holdings of Industry SuperFunds, but suspect a similar result to the property index.

Figure 7 – Rolling 5-year annualised Sharpe Ratio, March 2000- June 2015



Sharpe Ratio (June 1986-June 2015)	Australian Equities	Int Equities	Direct Property	Listed Property	Australian Fixed Interest	Int. Fixed Interest	Listed infrastructure*	Unlisted infrastructure*
	0.17	0.14	0.32	0.12	0.41	0.63	0.39	0.87

*Listed infrastructure from Dec 2013. Unlisted infrastructure from Sep 1995

Source: Bloomberg, IFM Investors

Note: The following indices are used: S&P/ASX 300 Index, MSCI World ex Australia Index (hedged in AUD), Australia Mercer Unlisted Property Index, Bloomberg AusBond Composite 0+ Yr Index, Barclays Global Aggregate Index, Bloomberg Bank Bill Index, S&P/ASX 300 Property Index, ASX Infrastructure Accumulation Index, IFM Australian Infrastructure Fund. The Sharpe Ratio is a measure for calculating risk-adjusted returns. It takes the average return earned in excess of the risk-free rate per unit of volatility or total risk.

- In addition to the higher net benefits for members arising from superior long term performance, illiquids including infrastructure are, compared to listed assets, much more strongly associated with capital formation and capital deepening, which lifts productivity growth. Reducing the capacity of the superannuation system to invest in illiquids would substantially undermine the country's economic prospects.

  Labour productivity growth is the most important driver of per capita income 'living standards' through time. Increasing real incomes give people the capacity to buy more goods and services, save and invest, as well as more freedom to choose how to spend their time. Higher incomes also generate more tax revenue for government services and income support. Higher productivity growth also supports a more stable inflationary environment which in turn underpins business confidence and over the long run and enhances the purchasing power of members' savings.

As the expansion of the Chinese economy cools, Australians face declining living standards as falling terms of trade imply that the world wants to pay us less for our goods and services. This is against a backdrop of low growth and low returns across the global economy. To maintain and raise Australian living standards in the current environment requires spurring growth in labour productivity.

Broadly speaking labour productivity growth is achieved through two means, capital deepening and multifactor productivity for a given labour force.[47]

Investments in newly produced assets tend to contribute significantly to measured labour productivity once assets are fully operational. By definition, a larger or deeper capital stock applied to a given workforce raises measured output per unit of labour.[48]

A comparison of the growth in public investment to the growth in labour productivity across 33 OECD member countries[49] between 1995 and 2013 suggests that raising the rate of public investment in the economy by 1 per cent would increase measured labour productivity growth by 0.1 per cent in any given year. This trend is confirmed in Figure 8 below. Applying this to an estimate of the total stock of Australian public infrastructure (in public and private hands) of $1.1 trillion at 30 June 2015, suggests that the stock contributes an additional $124 million to output each year.[50]

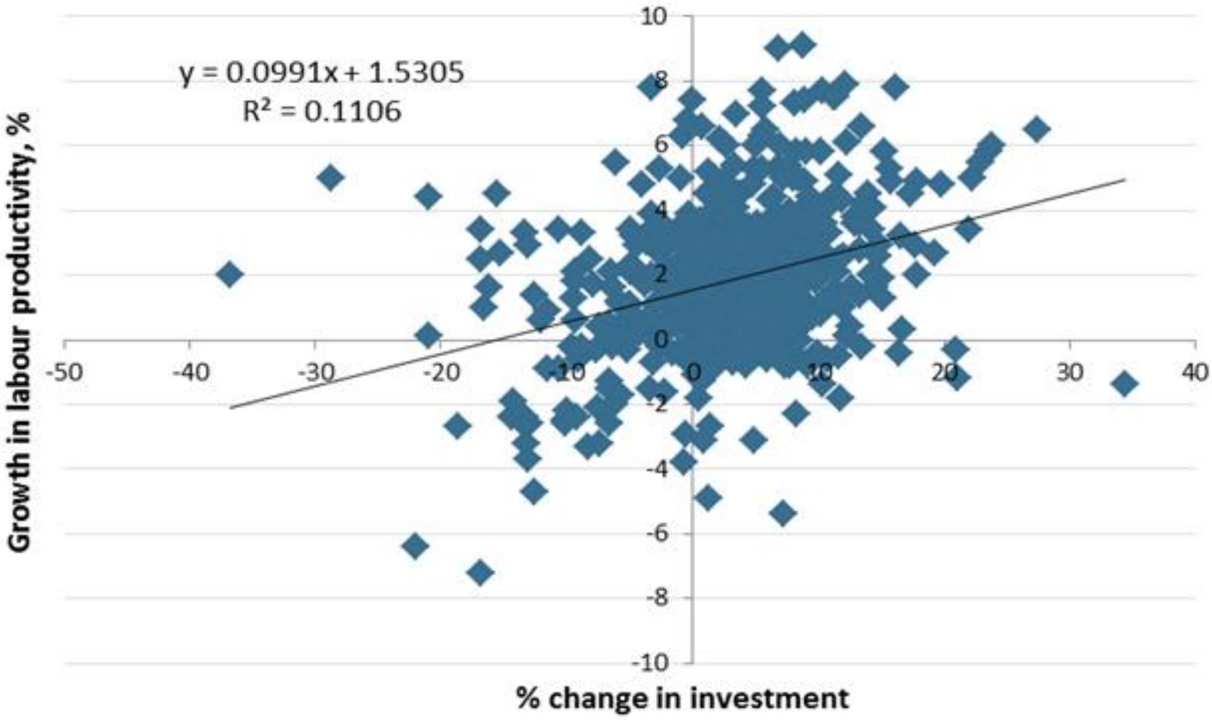
[47] The other major source of labour productivity gain is to invest in the quality of human capital through education and training

[48] Importantly, there is a clear empirical link between spending on public infrastructure and measures of labour productivity as estimated in the early 1990s, even if we now think the impacts are likely to be significantly smaller. See, Aschauer (1990).

[49] A subset of countries was necessary due to data availability and data quality.

[50] Industry super funds have added, or are managing up to $15 billion in public infrastructure assets out of a total stock of $1,085 billion. Assuming around one half of the $181 billion in annual physical capital expenditure by corporations flows to public infrastructure assets then the permanent increase in output via capital deepening is around 0.1 * $15/$1086 * $181* 0.5 = $124 million.

Figure 8 – Relationship between the growth in labour productivity and the growth in investment, 1995 to 2013



Source: OECD Stat

Note: Public investment is used due to the nature of such investment across OECD countries and the nature of the infrastructure assets owned by superannuation funds, which are almost exclusively public and social infrastructure.

Some reason that labour productivity gains achieved via total factor productivity (TFP) are preferable as they argue they lead to ongoing 'dynamic' efficiency gains which drive up growth rates through time. TFP, or broadly speaking, technological change generated via better industrial organisation, research and development (R&D), and deeper investment by business and government and spillovers associated with each, is usually attributed to the bulk of economic growth through time.[51] Robert Solow attributed 80 per cent of economic growth to such change.[52] But it should also be noted that the distinction between capital deepening and TFP is somewhat arbitrary as TFP measurement captures any technology and innovation impacts associated with new infrastructure. TFP growth rates are also impacted by levels of public infrastructure spending in economies. This is the reason why regenerating and extending a nation's stock of public infrastructure is so important as the technology embodied in the stock allows for spillover effects and a path of dynamic advance through economies.

Across OECD countries, there is a strong relationship between growth in public infrastructure investment and growth in TFP over time. We found that raising the rate of investment growth in public infrastructure by 1 per cent increases measured TFP growth over time by 0.13 per cent. This trend is confirmed in Figure 9 below.

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[51] Davis & Rahman, 2006, p 14

[52] Solow, 1957

Figure 9 – Relationship between the growth in multifactor productivity and the growth in investment, 1995 to 2013

Source: OECD stat

Note: 20 OECD countries were selected due to data availability (particularly multifactor productivity growth) and data quality. Public investment is used due to the nature of such investment across OECD countries and the nature of the infrastructure assets owned by superannuation funds, which are almost exclusively public and social infrastructure.

If the Australian superannuation system shifts its portfolio allocation away from appropriate real assets invested in over the long term, the country will have lower productivity growth and lower living standards.

Member protection when a fund loses default status

A further and important problem with both the auction and tendering models is how they propose that default members of funds that lose a future auction or tender should be treated.

In the auction model a fund that loses a future auction would be free of prior contractual negotiations and, unless they acted to leave, members would remain in the losing fund with protections provided by 'existing regulatory measures.' It appears that it would be a matter for default members to determine if their fund won or lost future auctions, and to make use of the publication of auction results to choose an alternative fund.

In the tender, prior obligations on the losing fund would also necessarily be lifted. But the Report argues that such 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.'

These suggestions for how default members of losing funds should be treated are irresponsible.

Since the foundation of our compulsory superannuation system in 1992 it has become widely, if sometimes reluctantly, accepted that most members of funds are characterized by disengagement, inertia, and levels of information and understanding that often either inhibit active decision-making or render such decision-making irrational.

The introduction of "Choice of Fund" over a decade ago, and efforts by government and the industry to increase engagement and financial literacy, have not fundamentally changed the approach that most workers take to their superannuation. To date most policy makers have recognized the need for default arrangements that protect those who make contributions but who do not or are not well suited to manage them.

What has been less acknowledged in the past, but is increasingly front-of-mind, is the extraction of value from members by for-profit financial institutions.

To argue that default members should remain in funds that have lost an auction or tender (and so have become free of prior contractual obligations in relation to fees and performance) unless those members decide to leave ignores the risk that these members will be exploited, and ignores the incentive effect of providers who participate in the auction or tender. The data regarding inactive accounts set out in Table 2, above, shows that members are not well placed to protect themselves from poor products.

The Draft Report's solution is illogical. On the one hand, the Report acknowledges that the present MySuper system does not offer a sufficient basis for protecting the interests of default members. On the other, the Report suggests that losing funds should be allowed to retain those members who do not act to leave on the basis that they would be offered 'some protection' by 'existing regulatory measures.'

Furthermore, the argument that default members of funds that lose a tender should not be notified of the result because their fund may still be good quality is unsupported by any evidence. It is also naïve because it does not discuss the very high risk that a losing fund, particularly one driven by profit-maximising criteria, will increase fees and charges after its contract with government has expired, meaning that even if the initial difference between a winning and losing fund is indeed marginal, it will not remain so.

The Report argues that requiring funds that lose an auction or tender to move members to a winning fund would be complex and disruptive, disadvantaging those members that remained.

If so, that speaks to the inappropriateness of the models for deciding default allocation, not to the need to expose default members to the risk of higher fees and lower net returns.

The Draft Report has presumably provided for default customers to remain with the firm that won the bid for them (reducing disruption) because, otherwise, the incentive for bidders would be much lower (since they could lose the customers in the next auction). This is on top of the risks of losing customers through marketing efforts by competitors and political action.

There appear to be no good answers for the Inquiry on these issues – a change to protect members undermines the effectiveness of the auction because it is no longer "winner takes all", undermining the motivations of the bidder.

But this is just one of the ways in which superannuation deviates from an ideal market for an auction or a tender. There are a number of other aspects of the superannuation system which suggest an auction or tender is the wrong policy tool, as explained below.

Superannuation is not an ideal subject for an auction or tender

The key conditions for an effective auction are set out in Figure 10 below.

Figure 10 – Ideal conditions for bidding markets

1. Competition is "winner take all", allowing no smooth trade-off between the price offered and the quantity bought (or sold).
2. The auctioned item is large relative to the market, or at least each bidder's total sales.
3. Competition begins afresh with each contract, with no path dependency or incumbency advantage.
4. Entry of new participants into the market is easy.

Source: Paul Klemperer, Bidding Markets UK Competition Commission (2005)

A tender or auction is not well-suited for allocating default superannuation members.

The tender cannot be "winner take all" unless the Inquiry eliminates the ability of providers to sell "choice" products to default members, and eliminates the ability of members to change provider. Doing so might cause other negative consequences.

The auctioned item is unlikely to be large relative to the market, or the membership of major bidders. Only a relatively small number of members, with relatively low initial average contributions, join the system in any given year.

Competition will be difficult to begin afresh with each contract, and incumbency is likely to have strong positive effects. This is because the incumbent will obtain valuable information, including about the nature of the pool of members and about the services to be provided.

New market entrants would have a difficult time participating in the auction or tender because of (i) limited potential to show credible capability, and (ii) a risk-return calculus involving significant upfront costs to develop the infrastructure to provide the services, and to prepare a bid, with high uncertainty about the probability of success.

"Best and final offer" stage could undermine the auction or tender

The 'best-and-final-offer' stage of the fee-based auction that the Draft Report proposes is likely to depress initial post-qualification bids because participants know that they will have a further opportunity to improve their bid.

This is likely to incentivize generalized under-bidding as participants attempt to game the setting of a fee-level that is sufficient to allow a final offer, while being lower than would be the case if the initial sealed bid was the only bid allowed.

In addition, by introducing additional auction or tender stages, the opportunity for coordinated action rises.[53]

Ethics and culture

The auction and tender structure are designed to create competition where it does not naturally occur, because there is an unwillingness to simply prohibit institutions with harmful culture and values from participating.

[53] See, e.g., Klemperer (2005) (stating that "The UK Competition Commission, for example, cites all of the following as facilitating coordination: few firms, high degree of market transparency, high frequency of firms' interactions, predictability of demand and costs, low likelihood of disruptive innovation, similarity of firms, lack of serious financial constraints on firms, long-term commitment of firms to the market, standardization of the product, inability of buyers to self-supply and difficulty of entry by new firms." (footnotes omitted))

However, by doing so, the Draft Report's proposal enshrines a new culture into superannuation, where it is expected, if not desirable, for institutions to seek to maximize their profits from members: that is the whole basis for the rivalry.

This view of human and institutional motivation – *homo economicus* – seems an important assumption that influences the Draft Report's worldview. But it has been empirically rejected.[54]

The fact that individuals and institutions can and do act based on "other-regard" and in socially considerate ways (when the environment indicates this is the desired and appropriate behavior) means the Inquiry does not need to go down the path of entrenching selfishness as the dominant paradigm in superannuation.

This is particularly the case in superannuation where there already are well-established not-for-profit institutions that continue to have strong cultures based on serving others.

Dehumanisation

The allocation of members under the auction and tender model dehumanizes them. This is likely to undermine the consideration given to these people by providers, and the officials who conduct the selection process.

[54] See, e.g., Gintis, van Schaik, and Boehm, Zoon Politikon: The Evolutionary Origins of Human Political Systems, *Current Anthropology*, Volume 56, Number 3, June 2015, at 327 (Stating that "The behavioral sciences during the second half of the twentieth century were dominated by two highly contrasting models of human political behavior. In biology, political science, and economics, a Homo economicus self-interest model held sway (Alexander 1987; Downs 1957; Mas-Colell et al. 1995). In this model, individuals are rational self-regarding maximizers. In sociology, social psychology, and anthropology, by contrast, a cultural hegemony model was generally accepted. In this model, individuals are the passive internalizers of the culture in which they operate. A dominant culture supplies the norms and values associated with role performance, and individual behavior meets the requirements of the various roles individuals are called upon to play in daily life (Durkheim 1902; Mead 1963; Parsons 1967), of which political participation is an important facet. Contemporary research has been kind to neither model. … Undermining the self-interest model began in economics with the ultimatum game experiments of Güth et al. (1982) and Roth et al. (1991). … These and related findings have led in recent years to a revision of the received wisdom in biology and economics toward the appreciation of the central importance of other-regarding preferences and character virtues in biological and economic theory (Gintis et al. 2005; Henrich et al. 2005; Okasha and Binmore 2012). It might reasonably be thought, however, that these behaviors are the product of the culture of advanced complex societies. To assess this possibility, a team of anthropologists ran ultimatum game experiments in which the subject pool consisted of members of 15 small-scale societies with little contact with markets, governments, or modern institutions (Henrich et al. 2004). The 15 societies included hunter-gatherers, herders, and low-technology farmers. This study found that many small-scale societies mirror the results of the advanced economies, but others did not. … Analysis of the experiments led to the following conclusions: (1) behaviors are highly variable across groups; (2) not a single group conformed to or even approximated the model of self-interested agents; and (3) despite the anonymous and asocial setting of the experiments, between-group differences in behavior reflected differences in the kinds of social interaction experienced in everyday life; that is, people generally conform to cultural rules of their societies, even when there is no chance a deviation will be punished. … The untenability of the self-interest model of human action is also clear from everyday experience. Political activity in modern democratic societies provides unambiguous evidence. … Perhaps the biggest problem [with the claim the individuals behave morally only due to incentives and the threat of punishment] is with moral actions that involve zero or very small social sanctions. This includes most forms of political participation, including voting, becoming politically knowledgeable, contributing to a campaign fund, and participating in a collective action. It also applies to moral actions that are prosocial but are not publicly monitored, such as giving to charity and being kind to strangers.")

3.2.4 Persistence of performance and the predictive power of fees

While neither a fee-based auction nor a multi-criteria tender is good public policy, a selection process that includes net returns is vitally important because of the ability of providers to hide fees in ways that resist standardized analysis and are only revealed by reduced performance over time (such as bid-ask spreads).

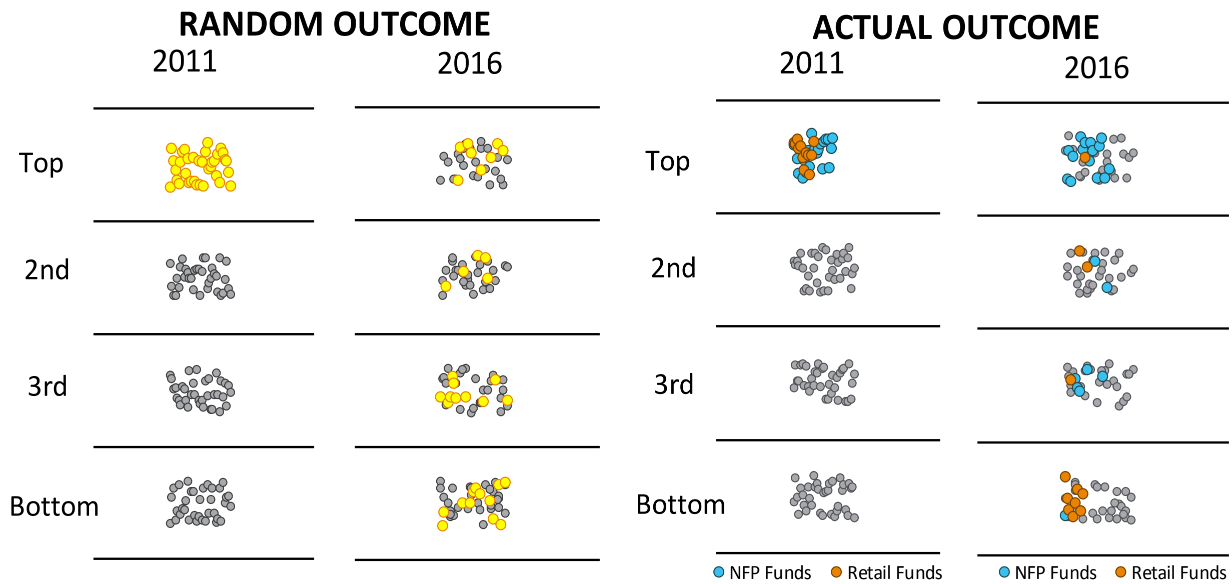
In addition, past performance in superannuation has strong predictive power.

We analyzed two contiguous periods of five year net returns of funds by quartile, to determine if the propensity for funds that were in the top quartile of net returns in the first five-year period were also in the top quartile during the second five-year period to a degree greater than what would be predicted if future performance is unrelated to past performance, i.e., a propensity attributable to pure chance.

If past performance had no predictive power, funds that were in the top quartile of net performance during the initial five-year period would have only a 25% chance of being in the top quartile in the second five-year period. We examined the propensity for funds (i) that were in the top quartile of net returns in the five-year period ended 2011 to also be (ii) in the top quartile of net return in the five-year period ending 2016.

We found that the probability of a fund being in the top quartile is nearly twice that predicted, with 46% of funds that were in the top quartile during the first five-year period also being in the top quartile during the second five-year period. This propensity is even higher for not-for-profit funds. We found that 65% of not-for-profit funds in the top quartile of the first period being in the top quartile in the second period.

Figure 11 – Persistence of high-performance in superannuation exists, and is very strong for not-for-profit funds



Source: APRA Annual Fund-level Superannuation Statistics, ISA analysis
Note: Period one is the five years ended 2011; Period two is the five years ended 2016.

Compared to the predictive power of net performance, the predictive power of low fees as they might be used in an auction or tender process is not as strong.

We examined whether being in the bottom quartile of fees[55] in the five-year period ended 2011 were in the top quartile of net return in the subsequent five-year period ending 2016.

We tested the predictive effect of low fees on future net returns because net returns – not fees – are the factor directly relevant to member benefit. This is because the key question is whether a selection process

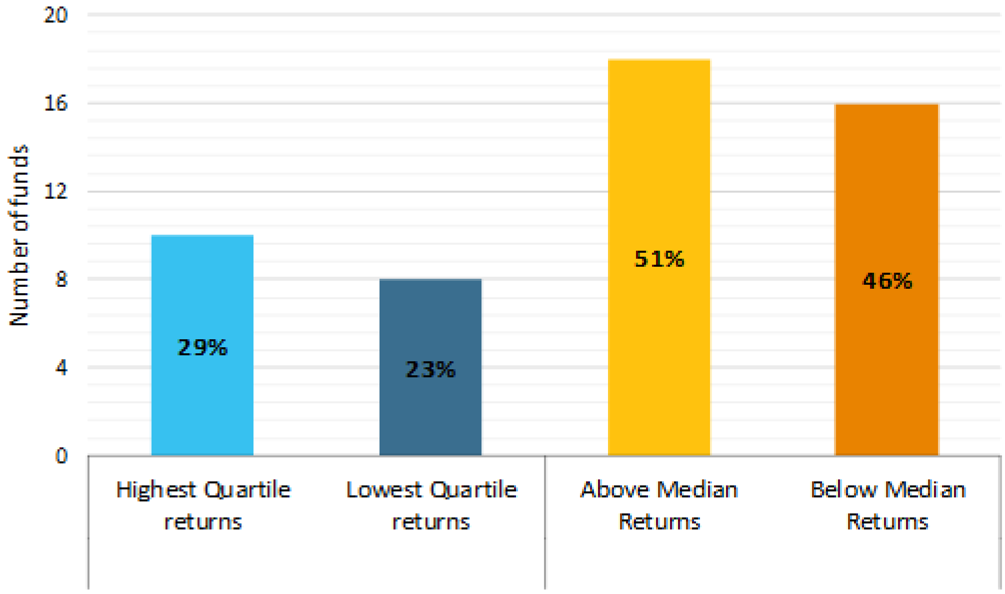
[55] i.e., those funds with the lowest fees.

focused on low fees would be reasonably likely to place members in the best performing funds in terms of net returns.[56]

We found that low fees in the first five-year period were not particularly informative in respect of the probability of a fund being in the top quartile of net returns in the second five-year period. Specifically, only 29% of the funds with the lowest fees during the five-years ended 2011, were in the top quartile of net returns for the five-years ended 2016 (Figure 12). This is not much different than what would be expected purely based on chance (i.e., 25%). Fees are not even good predictors of whether a fund will have above-median returns in the second period.

This suggests that a selection process based on fees alone would have a low likelihood of placing members in default funds that perform well over the long term.

Figure 12 – Predictive power of low fees: low fees do not predict high returns



Source: APRA Annual Fund-level Superannuation Statistics, ISA analysis
Note: The percentages above and below the median to not equal 100% because one of the 35 funds in the lowest quartile of fees in 2011 is now the median return for 2016, resulting in there being 18 above the median and 16 below.

Overall, net returns are a much stronger predictor of future net returns than are low fees. This reinforces the focus in of the Inquiry on net returns as a key factor in selecting default funds, and indicates that net returns rather than fees should be central.

3.3 Assisted Choice models

The Draft Report proposes two models based on choice: the first based on employee choice, the second on employer choice. We discuss the 'assisted employee choice' model first.

[56] Put another way, we did not evaluate whether low fees were persistent from period 1 to period 2 because a low fee product does not necessarily indicate a high performing product.

3.3.1 Assisted Employee Choice

Under this model, an independent government body would accredit a shortlist of perhaps 4 to 10 products from which employees can choose, with the assurance that each of the accredited products is of "good quality" and suitable for "a majority of employees."

Employees would remain able to choose any legally complying product, accredited or otherwise.

The Report argues that a product shortlist approach "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 encourage and facilitate choice by disengaged members while reducing the problems of 'choice overload' that can result from having to choose from a large universe of potential products.

Choice between shortlisted products would be assisted by the provision of "simple information" provided in a "consistent format" that would enable employees to choose the shortlisted product most suited to their needs.

It would be voluntary for a fund to seek accreditation, the granting of which would involve applying selection criteria equivalent to "a strengthened version of MySuper" that would be more sensitive to matters of performance and scale.

The accreditation process would run every 4 years. Members of a fund that loses accreditation would be notified of the loss but would not be automatically moved to another fund. The Draft Report argues that under this model "employees are responsible for choosing their own product" and so it is appropriate to expect them to initiate action to leave a fund that no longer meets their needs.

Employees that have not chosen a product, accredited or otherwise, will be placed in a "last-resort fund", a tightly regulated venue that would operate with a mandate to encourage members to choose a product offered by another provider.

In short, under the "assisted employee choice" model there are no default members. All employees are expected to choose a product of some sort, with a degree of protection offered in the form of a shortlist determined by an independent body. Non-choice is managed via temporary membership in a last-resort fund that actively encourages members to leave.

The Report concludes that the model offers some potential benefits to members: "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."

3.3.2 Comments on the Assisted Employee Choice model

The proposed 'assisted employee choice' model is not good public policy. No model of default selection that exposes disengaged individuals to high levels of selection and marketing risk is appropriate.[57]

The application of the 'assisted employee choice' model would involve abandoning the position taken by successive Australian governments and superannuation policy reviews over the past 25 years that if disengaged and low-information workers are compelled by law to participate in markets for products they

[57] The term 'marketing risk' as it is used here refers to the risk generated by the set of practices used by for-profit financial institutions to sell their products on terms that emphasise non-price/non-net return criteria. These practices include confusion marketing, bundling, branding and push-marketing. On the extensive use of such techniques to sell poor performing and/or inappropriate products to low-information customers by retail banks in the UK, see Bowman, A. et al (2014) *The end of the experiment? From competition to the foundational economy*, Manchester University Press.

do not understand, then government has an obligation to act to minimize the risk that they are exploited by the private organizations that manage their contributions.[58]

In place of a default system, the Report proposes a slightly modified model of full-employee choice. An independent government body will decide short-list of (hopefully) good quality products, numbering between 4 and 10, that because of their status as having been accredited and because of the smaller number of products to choose from, will encourage employees to choose one of the products on the list.

There are a number of significant problems with this proposal.

The proposal assumes a shortlist will transform members into good financial decision makers despite the evidence clearly showing this will not happen

The Report generally fails to take seriously the substantial body of evidence that exists and explains the reasons why most individuals cannot make rational decisions in relation to superannuation. The Draft Report recites and acknowledges the many behavioural risks in retirement incomes policy, much like a book report. But the proposals fail to take these issues into account.

In particular, the "Assisted Employee Choice" model limits itself to considering problems of consumer behaviour, psychology and literacy only in the context of discussing how long any accredited list of products should be. But this hardly exhausts the problems involved in placing primary responsibility for product choice on individuals.

The model rests on the assumption that shortlisting 4-10 funds and providing individuals with key information will transform individuals into savvy decision-makers. This is inconsistent with the evidence:

- Decades of experience in Australia and other countries shows that most employees are persistently disengaged from superannuation, and often make poor choices when they do engage.[59]
- Financial literacy and engagement strategies can create a risky mix of rising member confidence in decision making capability, but no material improvement in actual decision-making capability (or, ironically, decreased capability).[60]
- The view that "simple information" in a "consistent format" will materially improve decision making is not credible. Analysis of consumer understanding of food labels demonstrates that even very simple information provided in a very consistent format in respect of products that consumers actually want to buy is generally confusing to consumers.

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[58] The importance of a strong and effective default system to protect disengaged members was recognised by the Cooper Review in 2009 (Cooper et al. 2009) and by the Productivity Commission in its review of default superannuation in modern awards (Productivity Commission, 2012). There is no significant body of expert opinion in Australia that is not aligned to retail funds and the banking sector that argues against the need for a default system. This alone should caution the Commission against making any recommendation that involves increasing the ability of the for-profit sector to sell its products to disengaged individuals and employers.

[59] In our first submission to the Commission's present inquiry, ISA presented evidence that choice in superannuation is negatively associated with financial outcomes. See: Industry Super Australia (2016) *Living in an Empirical World: the best retirement income systems in the world rely on industrial defaults*, p. 8.

[60] See, e.g., Willis (2008), Against Financial Literacy Education, 94 *Iowa Law Review* 197.

See also, FINRA Investor Education Foundation (2016), Financial Capability in the United States (finding that the percentage of respondents able to correctly answer four out of five simple financial questions has declined from 42% in 2009, to 39% in 2012, to 37% in 2015, while the percentage of people who self-assessed their financial knowledge as "high" has increased from 67% in 2009, to 73% in 2012, to 76% in 2015.)

- Efforts to create useful "dashboard" style information for superannuation have been underway for many years with no evidence of success.
- Almost half of adult Australians have a level of literacy below the minimum level required to meet the increasingly complex demands of a knowledge society according to the OECD.[61]

The Murray Inquiry of 2014, the Productivity Commission in 2012, and the Cooper Review in 2010, have each catalogued a list of behavioural and cognitive problems (with supporting references in the research literature) that mean many individuals rarely make rational decisions when they exercise choice in superannuation. These include:

- The complexity of investment decisions and difficulty matching preferences with the right products.
- Information asymmetries between superannuation providers and individuals.
- A long lag between the purchasing decision and the time when the benefits can be assessed.
- An associated tendency toward procrastination and inertia in making retirement savings decisions.

But coming to grips with the behavioural and cognitive challenges of retirement income policy involves more than reciting a list.

These findings fundamentally challenge any public policy approach to retirement income based on individual agency, and need to be carefully considered in the development of recommendations.

The Draft Report does not do this.

Empirical testing of simple information, such as food labels, clearly shows that most people lack the literacy and quantitative capability to interpret even very simple information relevant to strongly desired products laid out in a mandated and consistent manner. Studies show that even though many people claim they read labels, they don't understand them: "in general [consumers] reported finding nutrition labelling confusing, especially the use of some technical and numerical information."[62]

If consumers struggle with food labels, the idea that superannuation members will be aided meaningfully by more complex information on less engaging superannuation products is difficult to credit.

In the context of the present Inquiry we recommend greater attention to this evidence be given as it relates to the 'assisted employee choice' model.

From a public policy perspective, we believe the evidence renders such a model irresponsible.

The model assumes that all employees can be properly regarded as choice members and should therefore assume the risks and responsibilities of being so.

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[61] See, Australian Bureau of Statistics, Programme for the International Assessment of Adult Competencies, Australia, 2011-12 (finding that 43.7% of Australians have literacy levels of level two or below on the six-level measurement system).

See also, Organisation for Economic Co-operation and Development (OECD) and Statistics Canada (2005), Learning a Living: First Results of the Adult Literacy and Life Skills Survey, OECD, Paris (noting that Level 3 capability is "the level considered by experts as a suitable minimum level for coping with the increasing demands of the emerging knowledge society and information.").

[62] See, e.g., Cowburn and Stockley (2004), Consumer understanding and use of nutrition labelling: a systematic review, Public Health Nutrition: 8(1), 21–28 (reviewing one hundred and three papers reporting on consumer understanding or use of nutrition labelling, and stating that "The studies found that although some consumers could understand some of the information on nutrition labelling, in general they reported finding nutrition labelling confusing, especially the use of some technical and numerical information" and "Although levels of self-reported label reading were found to be high, studies using verbal protocol analysis (a more objective method which elicits participants' thoughts as they are undertaking a task, the task in these studies was to make 'usual' and 'healthy' shopping choices using nutrition labels) suggested that consumers may simply look at the nutrition information panel but not process the information further.")

This is clear from how the model deals with members of accredited products that subsequently lose their accredited status. Because members of such products are regarded as having made a choice, the model proposes that it should be left to those members to decide if and when to leave a product that loses accreditation.

The proposed model offers a form of assistance to employees when they make an initial choice that does not fundamentally improve employee decision-making capability, and offers no protections when the safeguards are no longer applicable.

Doubling down on a decade of bad policy: Further retailisation of superannuation, salesmanship, and marketing

As the Report acknowledges, in practice the assisted employee choice model will provoke significant increases in marketing spend by funds who wish to attract members. Funds that previously limited their advertising spend because of workplace distribution, and so could focus on delivering benefits to members, are likely to be forced by external pressures to divert more of their resources into marketing. This is a useful reminder of the additional costs that competition can entail.

But in a universe of full choice, albeit one containing an accredited shortlist, formal marketing of superannuation products is unlikely to be the only way that some funds will seek to attract members. For example, new superannuation accounts could be bundled into a new bank accounts, credit cards, loans or insurance products.

Additionally, an employer may 'strongly recommend' that new employees join the firm's preferred superannuation product – one that has the added advantage to the employer of being provided by their bank along with other benefits.

In both these contexts, the decision to move from one product to another can be classified as 'choice' – but choice in a context where disengaged and low-information members are vulnerable to incentives and persuasion that may not be in their best interests.

Finally, and in common with our discussion of the other models proposed in the Draft Report, there is a risk that an accreditation body, appointed by government and making decisions with potentially significant implications for the profitability of the financial industry, could be subject to political interference and intense industry lobbying, in addition to being vulnerable to intellectual capture.

Other Costs

This model has a number of other intrinsic costs, including second round costs, which need to be considered.

Developing sufficient financial literacy and financial decision making capability to make sophisticated decisions (setting aside the intractable cognitive biases and information asymmetry) would take each individual a great deal of time and effort. It is unclear there would be a positive return.

In addition to developing capability, each individual would need to review their circumstances and assess some reasonable number of products. This would need to be done with some regularity. The (responsible) consideration of 4-10 products, combined with efforts to develop sufficient financial decision making capability (assuming that were possible) would be very costly. It is likely that consumers will also spend resources assessing products not on the list, especially due to marketing efforts.

Other costs include:

- Efforts to increase financial literacy can increase confidence while having no effect on actual ability, potentially leading to worse decisions.
- The "consumer choice" agenda blames consumers who experience below par outcomes or find themselves in in financial difficulty, deflecting calls for a more effective regulatory model.

3.3.3 Assisted employer choice

The fourth model proposed in the Draft Report is that of "assisted employer choice, with employee protections".

Under this model, employers could choose any default product offered by an approved provider, subject to the product meeting minimum criteria imposed by administrative filtering. Employers would be able to choose a default product from two lists: one comprising default products that meet certain mandatory minimum standards, and one comprising products that meet certain higher benchmarks (a "preferred default list".)

The 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". To be eligible for inclusion on this list, products would need to meet standards stronger than MySuper, based on a requirement to demonstrate "adequate performance". As a result the list will "exclude poor performing products" while leaving employers "with a large degree of discretion to choose default products".

The preferred default list "would focus on no frills products with higher suitability for default members".

The Draft Report argues that the number of products that could be included on the minimum standards list should not be capped because such a cap "could impose artificial constraints on competition and costs", but that there should be a minimum number of products on the preferred default list to ensure meaningful competition.

The filtering of products for inclusion on the two lists would be undertaken by a body whose members would be appointed by the Treasurer and would be expected to be "genuinely independent, free or conflicts of interest and accountable for their decisions".

The Report identifies some weaknesses and risks with the model. In particular, because employers do not receive the direct benefit of a good default product, they may have weak incentives to expend resources in selecting such a product. In addition, they may choose a default product for reasons other than what is in the best interests of employees, such as administrative simplicity or gaining low-cost access to other financial services.

On the risk that employers may be offered inducements by superannuation funds or others to select a particular default product, the Report notes that while Section 68A of the SIS Act prohibits such inducements, "contravention only gives rise to the possibility of future civil action by aggrieved individuals".[63]

The Report acknowledges that the principle-agent problems associated with employer choice remain a residual risk in this model. However, it is argued that the most effective way to manage these risks is via "a well-calibrated and enforced mandatory minimum standards filter" that "would safeguard against any mal-intentioned behavior by employers".

Overall, the Draft Report concludes that the dual-list approach to employer choice would "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."

[63] ASIC has observed that enforcement on the prohibitions on inducements is difficult. See, Statement of Commissioner Greg Tanzer, Senate Estimates Hansard, 11 Feb 2016, p50 ("Through our review, we found that there are difficulties in the implementation of specific enforcement action arising out of the section as it was designed, partly because it is a civil provision and does not carry a criminal penalty and partly because it is quite clear that the inducement has to be offered to the employer on condition that employees switch, and that is a difficult evidentiary burden to make.")

Comments on the Assisted Employer Choice model

The proposed 'assisted employer choice' model is not good public policy, and its analogue was appropriately rejected by the Commission in its 2012 Inquiry into default superannuation in modern awards.

Default selection should not rest solely in the hands of employers. This is for a number of reasons, some specific to the model contained in the Draft Report and some with more general purchase.

Firstly, while employers are obliged to deduct and pay superannuation contributions on behalf of most of their employees, those contributions are deferred wages and belong to those employees. Delegating the default selection decision solely to employers fails to recognize the industrial status of superannuation contributions and the entirely proper role that employees and their collective representatives should also play in determining the products to which contributions are made. This is one reason why ISA and many others strongly support default selection by collective industrial means.

Secondly, while the Draft Report acknowledges the principle-agent problems generated by employer choice the confidence that the proposed dual-list system will provide adequate protections for default members is unjustified.

In relation to the minimum standards list, the Draft Report appears to favour one that will facilitate a large degree of employer discretion, with an emphasis on excluding only the poorest products from being listed. This suggests a list of some length, one that would be very likely to include products characterized by a highly variable set of costs and performance histories. An argument for this list is that it would enable 'well-resourced employers' to negotiate good deals for their employees.

However, it appears that the decision by an employer to use the minimum standards list would be for each employer to decide. An employer could move from a high performing product on the preferred list to a poorer performing product (albeit one that does not constitute a 'very poor' product) while remaining fully compliant with default selection regulations. The Draft Report assumes that such a move would result from a large employer wishing to negotiate a better deal for its employees.

However, there is nothing in the model preventing an employer -- of any size -- from moving for other reasons.

Locating default selection in the hands of employers will invite significant marketing pressure from funds, and from retail funds in particular, that aims to shape employer decisions and understandings of what is in the best interests of employees. An employer may respond to such pressures in good faith, but with detrimental long-term implications for the financial position of default members. We know from existing research that many employers regard their superannuation obligations as a burden to be minimised.[64] In a context where employers would no longer have the contributions of a negotiated industrial or enterprise collective agreement, a choice encouraged by marketing pressures seems unlikely to be in default members' best interests.

An employer may also respond to material inducements to move. As the Draft Report notes, the SIS Act prohibits inducements to select a particular default product. However, because an inducement to move from a preferred to a minimum standards product would not breach the relevant default selection regulations, there would be no signal to a third party that an inducement had been improperly offered and accepted. Moreover, inducements are nearly impossible to observe and violations of this law are nearly impossible to enforce.

Alternatively, an inducement to select a product that is not contained on either list could be made. That such inducements are already prohibited by law has not stopped them being made. Research by UMR for Industry Super Australia found that among a sample of 550 SME employers in 2014, 43 per cent reported

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[64] See the research by Colmar Brunton Research for the ATO on employer attitudes to superannuation, published in 2010: Colmar Brunton (2010) *Understanding Superannuation Preliminary Report: Qualitative Investigation with Employers*.

that their bank had offered them benefits in exchange for changing their default superannuation fund. The benefits offered included lower insurance premiums for the business, free or discounted IT products for the business, and free tickets to sporting events or corporate hospitality.[65]

A solution to this risk is to prohibit a default superannuation provider from also providing business banking services to the same firm.

Thirdly, and previously discussed in the context of the other models suggested in the Draft Report, the 'assisted employer choice' model is likely to be vulnerable to political risk and intellectual capture. The specification of qualifying criteria for inclusion on the two lists is likely to be subject to considerable lobbying by industry interests and those elected representatives who are sympathetic to those interests. In addition, the membership of the selection body, while formally independent from participating funds, risks being appointed because they share the assumptions and worldviews of whatever government is in power.

Robustness against political risk and intellectual capture is best secured by having default selection undertaken by industrial parties in remove from, and acting as a counterweight to the financial sector, with oversight from public officials.

[65] Industry Super Australia/UMR (2015) *SME employer attitudes to superannuation*, Melbourne.

4. Responses to questions raised in the Draft Report

4.1 Information Request 3.1

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?*

Unfortunately, no useful response can be provided to this information request because the Draft Report's proposed models are too abstract, and the future conditions that would exist after implementation would need to be speculated without a solid foundation.

To sensibly answer these questions would require some understanding of (i) how the Draft Report's proposal would be implemented in practice, and (ii) the market dynamics prior to and after the selection process.

A cost-benefit analysis by the Inquiry, which outlined expected future conditions – including the behavior of different kinds of members, public authorities, and industry participants – and explained why they would occur, would assist. For example, what does the Inquiry believe about how many people in the "first-timer pool" of default members would remain in the initial product for six months, one year, five years, or indefinitely, and why? What would be the market share of various industry participants in the near term and long term, and why?

We do note the normative undertone of this information request assumes that members are a source of profit that would need to be sufficiently lucrative to encourage a provider to "participate".

4.2 Information Request 3.2

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?*

Please see the discussion of the merger proposals at Section 2.5.

In general, we recommend addressing the tax and legal uncertainty barriers to mergers, which the Draft Report ignored.

The number of successful mergers over several years does not weigh in favour of imposing a formal process for the consideration of mergers, though it is difficult to see how guidance about consideration of mergers would be harmful.

The Draft Report's transparency proposals are susceptible to mischief, place inappropriate power in the hands of potentially adverse parties, and it is not clear what they (responsibly) contribute beyond existing disclosure requirements.

4.3 Information Request 3.3

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.

Unfortunately, a useful response cannot be provided for this information request for the same reasons as in respect of Information Request 3.1

We again note the normative undertone of this question, which seeks to estimate that "value" of the pool of default members (to a potential provider).

4.4 Information Request 5.1

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?

The assumption underlying the question about the proper size of the shortlist assumes that simply changing the presentation of options will enable individual agency in superannuation that improves wellbeing.

As discussed above in 3.3.2 and *passim* elsewhere in this submission, simply reducing the number of choices will not necessarily need to good choices and is a misreading of the literature on behavioural finance, and of the studies about human ability to process information and make decisions.

The barriers to welfare-enhancing individual agency in superannuation is not just, or even primarily, "choice overload".

Research into the challenges with individual agency in consumer finance has raised strong objections, focusing on "four intractable barriers":

> [T]he information asymmetry between sellers and consumers created by the complexity of financial products and the speed with which they change; the very low level of computational abilities possessed by most consumers; widespread decisionmaking biases that impair consumer financial behavior; and the disparity in resources with which the industry versus educators [including government] can reach consumers. [66]

There are no "nudges", shortlists, or light-touch policy solutions that can inoculate members from the ability of the banks and other for-profit providers to flog super products while calling it "choice".

Moreover, even if consumers were somehow able to navigate the predatory environment of a sales/choice-driven superannuation system, it is not clear that the substantial costs on each consumer, each provider, and government, for each search and transaction would be justified by material benefits. There is no basis for the view that there are strong, natural,[67] individual preferences about retirement income that would somehow be addressed in a choice market. The 70% replacement rate objective is substantially universal.

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[66] Willis, note 60 above.

[67] i.e., which do not arise from sales efforts of providers.

In the absence of a sales interaction, individuals do not express or have strong preferences (especially about "products"): they just want to have a decent living standard.

Once wealth is achieved beyond that sufficient to maintain living standards, there is an argument for individual agency in respect of this additional wealth: (i) the questions relating to such additional wealth are largely questions about how and when to consume it, and (ii) the social policy objective of the superannuation system will have been discharged (meaning any individual agency that results in self-harm (only) is not a major public policy concern).

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?

The most important information that is relevant to long term net performance of a superannuation fund is its historical performance and profit orientation.

Based on existing research into financial capability,[68] the experience so far in Australia with product dashboards (including that for-profit providers have resisted fair disclosure of net returns and of fees and costs in them),[69] and experience with financial literacy, there is little evidentiary support for the Draft Report's position.

Indeed, the idea that for-profit providers will provide clear disclosure seems fantastical. Efforts by ASIC to simply ensure comparable disclosure of indirect costs in superannuation and managed funds has fallen victim to manifold layers of complexity and the resistance by providers.

We also note a danger to consumers with respect to simplified disclosure and "metrics". Efforts have been made in the past to develop very simply disclosure items to facilitate comparisons. One example is the "annual percentage rate" (or APR) construct used in the USA to support comparison of consumer credit products, such as credit cards and mortgages, by reference to a single metric that incorporates both interest and fees. However, this ostensibly good idea has lead consumers to be victimized by fees and costs that are not included in the APR – such as late fees in the case of credit cards. It also left consumers unable to make decisions where the mix of factors underlying the metric are different.[70] Consumers who did adopt a "lowest APR" rule of thumb had little allegiance to it in the face of sales techniques because they did not understand it.[71]

It will not be long before most people join the cynics who conclude that policy makers who continually promote "better" disclosure, even when it never delivers what is promised, are really just protecting finance sector business models based on sales (choice).

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

There purported need for a "last resort" fund is entirely a consequence of the insistence in the 'assisted employee choice' model not to have a default. Since defaults truly are necessary in super (in the absence of mandates connecting workers to providers), the 'assisted employee choice' model creates a new label for it, the "last resort fund". This label does help underscore the objective of the model, which is that all members are choice members, regardless of wellbeing.

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[68] Discussed in Section 3.3.2 above.

[69] CITE – ISA submission but ideally others as well.

[70] For example, two loans with the same APR and term but different combinations of points, fees, and interest.

[71] Willis at 220.

Regarding the Future Fund as the "last resort fund", this seems unnecessary and risky. It is unnecessary since the shortlisted funds in this model should be adequate. It also seems risky since (i) the Future Fund does not have a member-facing capacity, being a sovereign wealth fund, and (ii) is clearly a government vehicle which could create interest in transferring risk of loss.

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?

The Draft Report envisions a system where private sector for-profit financial institutions can bid for or win pools of default members. As we already point out, such an outcome will deliver to the for-profit part of the super system a ready-made, government sanctioned, customer base at a very low acquisition cost.

Without specific prohibitions, they will up sell and cross-sell other products. Even sophisticated members under professional advice enter into these products, and wind up poorer. Yet the proposal in the Draft Report would furnish for-profit institutions with customer base of less engaged default members, who are likely to be even more susceptible to being cross-sold products that may not be in their interests (and leave them worse off overall).

Many banking products such as credit cards and insurance don't have any best interest duty attached.

These are much higher margin products (credit cards certainly are) and there is an unacceptably high risk that such institutions may loss lead so they can sell other products to their newly (and cheaply) won customer base.

This commercial imperative (and reality) is one of the most acute risks in the Draft Report's proposals.

At a minimum, prohibitions on up-selling superannuation products, and cross-selling and discounts on unrelated products, must be part and parcel of any model the Inquiry puts forward.

However, such prohibitions are likely to be workable or enforceable when introduced, and even if they were would be mercilessly eroded through lobbying, "financial innovation" and regulatory arbitrage.

The Draft Report's proposal around 'assisted employee choice' has enough challenges without introducing additional options, opportunities and sales techniques to providers.

4.5 Information Request 6.1

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?

As discussed in the commentary on the fee-based auction model in Section 3.2.3, it is not clear that the superannuation system is well-suited to an auction approach. Issues include: members allocated pursuant to the auction might exit the product to a competitor the next day, auctions rest on a set of cultural values that are not desirable in superannuation, the auction process (and regulatory environment) is susceptible to exploitation by banks and other for-profit providers, among other things.

If an auction were adopted, the "best-and-final-offer" stage seems likely to undermine the endeavor for the reasons outlined in Section 3.2.3.

Transparency should be complete. In addition, reporting by auction winners should include ongoing disclosure of any margins and profits made from the provision of default services, the number of members switched into products offered by affiliates, and the number of financial products cross-sold to members initially allocated through the auction.

4.6 Information Request 7.1

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?

The member services that need to be provided include (i) account administration (including online access to basic information and periodic reporting), (ii) professional investment management, (iii) intrafund advice to respond to any questions raised by members about the benefits to which a member is entitled (including telephone support).

Because we believe the default product should be a whole-of-life retirement income product, the capacity to make periodic payments of retirement income should be a component of account administration.

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?

We recommend industry-based defaults for the reasons specified in Section 3.1.3. Default members should be allocated based on their industry of employment.

We do not believe that products which win this tender process should have wildly varying investment strategies, fees, and services. Their actual performance might vary to some degree due to different specific assets within strategic asset allocations, but "best practice" in respect of institutional investment is fairly well known and no winning fund under this model should deviate from it.

For information about such "best practice", the Future Fund subscribes to it and provides disclosure about its interpretation. Industry SuperFund investment strategies also follow best practice, which is why their approach to illiquids and thematic investing is substantially similar.

We question the utility of a best-and-final-offer stage.

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?

The tender process should be conducted on an open-book basis. Providers of default services are performing a public function in furtherance of a social policy objective.

In addition, reporting by tender winners should include ongoing disclosure of any margins and profits made from the provision of default services, the number of members switched into products offered by affiliates, and the number of financial products cross-sold to members initially allocated through the tender.

4.7 Information Request 8.1

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?

The main costs on employers relate to due diligence of products and providers. There also are administrative costs, but these are generally marginal since payroll and HR software and procedures include superannuation.

A shortlist does assist employers.

In the absence of a short list, we estimated that the additional cost imposed on employers, should they be required to select a MySuper default fund unaided by named list within a modern award, would be in excess of $160 million.[72] This was a conservative estimate, as it assumes that an employer takes only four hours to undertake due diligence and select an appropriate workplace default fund from authorised MySuper products. A conservative maximum cost of $50 per hour is allocated to cover the employers search costs. This cost includes direct and indirect costs such as an allocation for the employer's time and opportunity cost. Because these costs are repeated for each employer, the small to very small businesses segments will bear the bulk of the cost.

The shortlist should be short.

The Draft Report's proposal of a "dual-list" approach is inefficient and arises because the Draft Report insists on national defaults rather than industrial defaults.

If there was a true shortlist of industrial defaults, this would reduce employer search costs while also enabling appropriate tailoring of the default to the industry.

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[72] In June 2012, there were 835,187 employing businesses in Australia - ABS (2012) Counts of Australian Businesses, including Entries and Exits, Jun 2008 to Jun 2012, Category 8165. Accessed 17 January 2014 available at http://www.abs.gov.au

Assumes hourly cost of $50, and 4 hours search time. Business size: Very small 1-4 employees, Small 5-19, Medium 20-199, Large 200+

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Consider a fund's PDS and your objectives, financial situation and needs, which are not accounted for in this information before making an investment decision.