



Response to Productivity Commission Issues Paper: Superannuation: Alternative Default Models

28 October 2016

AIST Submission

AIST

The Australian Institute of Superannuation Trustees is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public-sector funds.

As the principal advocate and peak representative body for the \$700 billion not-for-profit superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

AIST provides professional training and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.

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1 Executive summary

Australia's compulsory retirement savings system is now more than twenty years old. Notwithstanding the significant regulatory change over the past five years, the vast majority of Australian employees continue to rely on default funds, either because they are not engaged or they choose not to exercise choice of fund and trust that the default fund will serve and protect their best interests. As a result the majority of Australian employees become members of a superannuation fund through default fund allocation arrangements.

This submission – framed in the context that millions of Australian's could have their lives significantly altered by recommendations of the Commission concerning default fund selection - raises the following key points:

- **Members' best interests must drive the default fund selection process:** In its important deliberations the Commission should at all times ensure that the best interests of fund members have primacy. The criteria for assessing alternative default models must have a principle criterion of members' best interests.
- **Default fund allocations impact both the individual and the taxpayer:** The public has a significant investment in and is impacted directly by retirement outcomes flowing from default allocation decisions: the cost of choice errors or a poorly operating default system are borne by both the individual as well as current and future generations of taxpayers. It is therefore appropriate that the public fund a process that ensures as far as possible, appropriate and superior outcomes.
- **Competition is a means but not an end in itself:** Efficiency and how it can benefit fund members should be the driving force behind the Commission's deliberations. Competition, to the extent that it is a good, should be seen as a means to improve efficiency, not an end in itself.
- **International comparisons do not support alternate models:** AIST observes that the Chilean model of short-term tendering for default fund services has reduced administration costs, however, this has not to date been reflected in superior member returns and is unlikely to do so. The short-term investment horizon flowing from 2 yearly tenders will inevitably result in restricted investment opportunities to the member's detriment. The introduction of a Chilean-style system is inappropriate and potentially costly to retirees and taxpayers.

- **Market-based models likely to have inferior outcomes for members:** Superannuation is one of the pillars of retirement savings and as the Commission has observed in recent a recent inquiry into defaults that the superannuation market ‘lacks traditional market forces’. This submission rejects default allocation models which are based on market forces or models which force consumers, who may not be willing or in a position to do so, to choose. It is suggested that the market and member active choice models will have inferior results for both individuals and the taxpayer. AIST prefers a continuation of an administrative model. Such a model will ensure appropriate filters are applied to ensure that there are adequate member protections.
- **Poor financial literacy and complex decision making means consumer protection is paramount in the default fund selection process:** The evidence is that far too many Australians do not have the required levels of financial literacy to choose a superannuation fund that it is in their best interests. Many of those who select funds in the choice environment have experienced inferior outcomes, with poor data and sub-optimal disclosure further complicating the decision-making process. This submission argues that government regulation must extend to the selection of appropriate high performing default funds.
- **The need for a MySuper filter:** MySuper provides a minimum standard but does not regulate fees or outcomes. There continues to be a wide spread in fees and returns among MySuper products and, as such, the standard or operating filters for default fund selection should be higher.
- **The existing default system has delivered:** Existing default funds have consistently, over a long period, delivered significantly superior returns and appropriate services to members. The selection of appropriate default funds can make a difference of tens of thousands of dollars in retirement balances. There remains an overwhelming case for the continuation of default fund arrangements that are efficient and work in the best interests of members.
- **Existing default system should be the baseline for comparison:** It is entirely appropriate that the starting point or objective baseline against which alternative systems are measured, be the existing system, not as the Commission suggests, a no default baseline.

- **Existing Fair Work process should be given an opportunity to work:** Superannuation is a form of deferred wages and it is entirely appropriate that the selection of default funds be undertaken within the industrial relations environment; particularly as the existing default allocation system undertaken has produced superior outcomes. The Fair Work Commission's new default selection process is yet to be implemented and has within it a level of competition and segmentation that ensures that only the best performing and most appropriate funds are selected as default funds. This process should be given an opportunity to work.
- **Transition risks should not be underestimated:** Confidence in superannuation is paramount, particularly in a compulsory system. Any changes to superannuation have the potential to fuel uncertainty and lead to significant costs that are ultimately passed on to members. Changes to the existing default system – which we argue has a solid track record – are potentially an enormous undoing of Australia's retirement incomes system, affecting not only members and super funds, but also the wider financial services sector – from custodians, investment managers through to administrators. We urge the Commission to consider these impacts when reviewing potential alternate models.

2 Introduction

AIST welcomes the Productivity Commission's inquiry and looks forward to working with the Commission in its examination of the relative merits of the existing and alternative arrangements for the allocation of members to superannuation funds. AIST supports an efficient superannuation system that will better serve fund members and society.

Over recent years there have been a number of reviews of the superannuation system, including a review of the default allocation process by the Productivity Commission. AIST believes that there must come a point in this process of ongoing review and associated regulatory change where the focus turns to the importance of stability. Superannuation is a long-term investment and stability fosters confidence, which in turn facilitates a long-term approach to investment. We urge the Commission to consider the impacts on members' retirement savings when reviewing potential alternatives to the current system that has been successful in selecting default funds that have delivered on average superior returns to members.

In this submission we suggest that the Commission's deliberations should be centred by member best interest considerations and that these should be the overarching and determinative principle which influences decision making on this matter. The key driver of member's best interests is the long-term risk adjusted net return provided to members by the system and an appropriate level of unconflicted services adding value to the member experience. The objective should be to provide an adequate income to ensure all Australians achieve a comfortable standard of living in retirement, supplementing or substituting the Age Pension.

3 Superannuation: Part of a wider retirement incomes system

Australia's superannuation arrangements, including default allocation processes, are an integral component of a wider retirement incomes system. Decision makers should be mindful that changes to superannuation arrangements, including default fund allocation processes, will have an impact on Australia's retirement incomes system and could undermine confidence in the system.

Whilst recognising the terms of reference for this review, it is suggested that the examination of matters such as members' best interests, sustainability, integrity and system costs are impacted by decisions outside the superannuation system. For example; the availability of and timing of tax concessions will directly impact superannuation product design and appropriateness for certain demographics. All these, and similarly influential matters, should be capable of being considered when default fund allocation decisions are being made.

As noted, the objective of superannuation should be to provide an adequate income to ensure all Australians achieve a comfortable standard of living in retirement, supplementing or substituting the Age Pension.

4 Rationale for defaults

There remains a strong case for the continuation of default funds. The vast majority of Australian employees do not exercise their right to select a superannuation product both when they commence employment and when they change positions. Australians have a right to ensure that the compulsory superannuation system is both efficient and protects and works in their best interests. Superannuation is a form of deferred wages and as such is an integral component of an employees' remuneration package and the relationship with their employer.

An efficient superannuation system is one that ultimately delivers the best possible net returns to members and the delivery of appropriate services such as insurance that operate in the best interests of members. A regime that ensures employees are allocated to the best performing and most appropriate funds is essential to ensure the individual and public interest is protected.

The Australian taxpayer subsidises the superannuation system and underwrites risk through the provision of the Age Pension safety net. It is entirely appropriate that a strong consumer protection and regulatory process ensure that only those funds that operate in the best interests of members are selected as default funds.

Any system changes that decrease member protection and increase cost to society is not appropriate.

The Issues Paper briefly discusses the rationale for default fund arrangements. We concur with the Commission's statement that the superannuation system has matured since the introduction of default fund arrangements. We also agree with the Commission's observation that the system has also been improved through improvements in transparency and accountability.

If system maturity is to be measured by the number of employees who will experience a working lifetime of superannuation contributions at the rate of 9.5% or higher; then the system must be considered immature as this goal will not be achieved for approximately another 30-35 years.

Future considerations of maturity could include increasing engagement, awareness and financial literacy, regardless of whether defaults or choice dominate the members' approach to superannuation. If we consider a mature system to be one that is characterised by many products competing for informed, engaged and economically rational customers; then this reality is a distant concept.

The significant Stronger Super suite of reforms¹ flowing from recommendations of the Super System Review (the Cooper Review)², including the introduction of MySuper and associated regulatory change, has improved transparency, accountability and efficiency.

In its Stronger Super response the Government claimed its response would:

Deliver better outcomes for members and their employers by:

- *Creating a new simple, low cost default superannuation product (MySuper);*
- *Raising the bar for those managing our superannuation system, particularly for those managing default superannuation funds in which the majority of Australians invest;*
- *Providing APRA, ASIC and the ATO with the tools they need to improve their oversight of superannuation; and*
- *Making the processing of everyday transactions easier, cheaper and faster (SuperStream).³*

Notwithstanding more than twenty years of compulsory superannuation arrangements and by any measure some maturation of the system, including its regulatory environment, there has not been a parallel increase in member engagement.

The Final Report of the Financial System Inquiry recognised that the superannuation system lacks traditional market forces and that there is a case for Government intervention (following page):

Government intervention in the superannuation system is warranted to improve the system's efficiency in the accumulation phase. The system lacks traditional market forces, due in part to substantial government intervention. Also, the outcomes of the

¹ In December 2010 the Federal Government released its Stronger Super agenda which accepted 139 of the 177 Cooper review recommendations.

² The review's final report was released on 30 June 2010

³ Shorten, W. (2010). *Stronger Super*. Government Response to the Super System Review (Cooper Review). [online] Canberra: Commonwealth of Australia, Page.1. Available at: <http://tinyurl.com/hn29u2w> [Accessed 25 Oct. 2016].

*superannuation system ultimately affect both its members and taxpayers through the level of Age Pension payments.*⁴

Most employees who have the option of exercising choice of fund do not do so. It is reasonable to argue that employees rely on a government regulated system to ensure their interests are protected. In this submission we argue that government regulation must not only ensure superannuation savings are collected, but also extend to the selection of appropriate high performing default funds.

4.1 Complex decision making

We agree with the Commission's view that retirement decision making is complex. The Commission has previously identified the difficulties faced in making retirement savings decisions.⁵ These difficulties included:

- Lack of financial literacy,
- Complexity of investment decisions;
- High search costs;
- The 'endowment effect' where people place more value on money lost;
- Lack of price awareness;
- Information asymmetries;
- A long lag between the initial investment and benefit payment;
- An associated tendency toward procrastination;
- Mental rules or short cuts (heuristics) which can lead to persistent biases; and
- Framing effects, where people choose based on how options are framed rather than what is in their best interests.

With continuing low levels of financial literacy in Australia,⁶ the propensity of consumers to make complex financial decisions is not likely to improve in the near future. It is therefore not

⁴ Murray, D., Davis, K., Dunn, C., Hewson, C. and McNamee, B. (2014). *Financial System Inquiry Final Report*. November 2014. [online] Sydney: Commonwealth of Australia, p.108. Available at: <http://tinyurl.com/n7wl3lb> [Accessed 25 Oct. 2016].

⁵ Productivity Commission, (2012). *Default Superannuation Funds in Modern Awards*. Report No. 60, Final Report. [online] Canberra: Commonwealth of Australia, Box 1, p.4. Available at: <http://tinyurl.com/qxct8jo> [Accessed 26 Oct. 2016].

surprising, as the Commission acknowledges on page two of the Issues Paper that a considerable number, in the order of two thirds of fund members, rely on default arrangements.

The *Australian Financial Attitudes and Behaviour Tracker* report Wave 4⁷ found that 30 per cent of surveyed Australians find dealing with money stressful and overwhelming. This indicates no improvement since the inception of the survey. Further, the survey has found a decline⁸ in the number of people who said they spend a lot of time thinking about financial information before the making of a decision.

The survey also found that under 35 year olds are more likely to indicate that they have difficulty understanding financial matters. Relevantly for these considerations, the survey reports that only one in three Australians have ever heard and understood of the concept of risk/return trade-off and that two in five Australians have ever heard of the concept of diversification.

Admitted levels of financial literacy levels in Australia are low, particularly amongst certain cohorts, including the young and low income earners. Estimates of financial literacy based on answers to basic financial questions are arguably considerably lower.⁹

When choosing a superannuation fund basic concepts of risk and return trade-offs and diversification are required. The evidence is clear that far too many Australians do not have the required levels of financial literacy to choose a superannuation fund that is in their best interests.

The work of Delpachitra and Schumann¹⁰ suggests members of default funds see themselves as consumers not investors and lack the ability or time to monitor investments in a way required by a system that assumes a sophisticated investor.

⁶ Australian Securities and Investments Commission, and EY Sweeney, (2016). *Australian Financial Attitudes and Behaviour Tracker, Wave 4: September 2015 - February 2016*. Key Findings, ASIC Report 481. [online] Canberra: ASIC. Available at: <http://tinyurl.com/hlt4ve7> [Accessed 26 Oct. 2016].

⁷ ASIC and EY Sweeney (2016), cited above. Research undertaken by EY Sweeney on behalf of ASIC which is framed around the five indicative behaviours of financial literacy identified in the 2011 ANZ Survey of Adult Financial Literacy in Australia and the 2014 Financial Literacy Strategy led and coordinated by ASIC.

⁸ 57% in 2014 to 52% in 2016.

⁹ Agnew, J., Bateman, H. and Thorp, S. (2013). Financial Literacy and Retirement Planning in Australia. *Numeracy*, [online] 6(2), Article 7. Available at: <http://tinyurl.com/hv662dg> [Accessed 26 Oct. 2016].

4.2 The trust placed in defaults

The actual number of default fund members who consciously choose to adopt a default fund (and are therefore invisible as choice members) is unknown. There is consensus that the vast bulk of Australian employees fail to actively exercise their right to choose a superannuation fund and as a consequence there is a need for an efficient process for the allocation of members to funds. The allocation process should be designed to operate in the best interests of both members and society.

It is submitted that there is a considerable level of trust in the default process by Australian employees. It is suggested that there is a public assumption that mandated superannuation contributions will be made to a suitable fund. Notwithstanding the lack of fiduciary responsibilities held by employers to employees within the Australian jurisdiction, there is an assumption that there is a sufficient level of regulatory control and oversight. Whilst banking and insurance scandals may have undermined the public's confidence in the financial system's ability or desire to operate in their best interests, this is not necessarily the case in the superannuation environment, particularly regarding not-for-profit public sector, corporate and industry funds.

Many consumers trust the default fund they are placed in and have a level of confidence that within such a system there will be enhanced consumer protections and standards. Internal research by industry funds consistently demonstrates a high level of trust in default funds that surveyed members have been allocated to.

The Commission's *Default Superannuation Funds in Modern Awards* Final Report observed that: "The failure of many employees to make an active choice is the primary rationale for having a default superannuation system."¹¹

This 'failure' to choose continues and consequently the rationale for the continuation of default fund arrangements continues.

¹⁰ Delpachitra, S. and Rafizadeh, S. (2014). The Switching Decision: Are Members of Superannuation Funds Rational and Informed Investors? *Australasian Accounting, Business and Finance Journal*, [online] 8(4), pp.45-62. Available at: <http://tinyurl.com/zc88vth> [Accessed 26 Oct. 2016].

¹¹ Productivity Commission (2012), cited above at page 3.

5 Baseline for determining defaults

On page five of the Commission's Issues Paper the Commission states its preference for not having default arrangements within Australia's superannuation system. The Issues Paper then clarifies that the Commission will assess its own nominated alternative allocative models against what is described as the Commission's preferred no-default objective baseline.

It is suggested that a preferred approach would be to not commence this inquiry with a predetermined preference or baseline, other than the existing arrangements.

It is unclear how the Commission's preferred, objective baseline for this inquiry can properly be having no defaults. A baseline in this context is a clearly defined starting point or point of departure from which measurement begins, improvement is judged or comparison made.

An objective assessment of that baseline involves an impartial, detached and fact-based assessment.

It is suggested that the Commission's role is made significantly more difficult as a result of its choice of using no defaults as a benchmark. This chosen benchmark is an entirely hypothetical and abstract concept which provides no real-life guidance or metrics against which the costs and benefits of alternative allocation methods can be assessed.

There is clear evidence, such as that found in Table 1, that existing default arrangements have provided superior outcomes for members.

5.1 Starting point should be current default allocation processes

The starting point for the Commission should be an acceptance that the majority of workers do not actively choose their superannuation fund and that default allocation methods are therefore required. It is unclear why the Commission considers that a no-default position could be considered as "... a new allocation model"¹² because twenty five years have passed since the introduction of a universal superannuation regime. Whilst the superannuation system has grown along with Australians personal investment in superannuation, this in itself is not an indicator of maturity. There has not been an improvement in the level of engagement Australians have with superannuation anywhere near commensurate with the growth of accumulation accounts.

¹² Issues Paper, page 17.

If alternative allocation methods are to be measured against a theoretical baseline the Commission should have a very clear idea of the costs and benefits associated with that baseline. Only by doing so can the Commission determine the relative merits of alternative proposed methods to each other, and the baseline.

No doubt that the Commission will enter this inquiry with an open and pragmatic mind. If the Commission seeks change in the best interests of members and society it would be aided by concentrating on real life behaviours and scenarios.

We suggest that an appropriate baseline from which to measure alternative allocation methods should be the existing default allocation arrangements. It is submitted that the existing arrangements provide a baseline that can be measured. We can measure the outcomes of net returns provided to fund members over the long-term; we can measure levels of compliance and coverage; we can measure adequacy and forecast long-term returns and importantly, the resultant impact on Australia's retirement incomes system.

The Commission should also be mindful that the existing default allocation system has allocated funds that have consistently outperformed and has been amended to include additional filters and assessment processes with a view to further improving outcomes.

5.2 Existing default allocation process

Australia's default fund arrangements have allocated members into funds that have on average provided higher long-term net returns to members.

In previous work the Commission has recognised that there is a lack of consensus on findings related to the persistence of superannuation returns, particularly when accounting for risk factors¹³. We submit that the evidence is clear that those funds that have been allocated as default funds over the past two decades have significantly outperformed¹⁴.

The introduction of new standardised MySuper products, whilst to some extent reducing the spread of fees and costs; has not resulted in any challenge to the outperformance of default funds.

¹³ Productivity Commission (2012), cited above.

¹⁴ Deloitte Access Economics, (2012). *Persistence in Superannuation Fund Returns*. Prepared for Industry Super Network, 24 June 2012. [online] Melbourne: Industry Super Network. Available at: <http://tinyurl.com/zs3ezax> [Accessed 26 Oct. 2016].

Not all MySuper products are the same. There continues to be a wide spread of fees and charges and importantly, returns to members.

5.2.1 Snapshot of returns to 30 June 2016

Independent ratings agency SuperRatings recently released its assessment of the top 10 performing funds over a three year period to 30 June 2016. All of the top ten products are MySuper products operated by not for profit funds. The SuperRatings 10 year return for SR50 Balanced (60-75) Index funds to 30 September 2016¹⁵ shows not for profit funds on average outperforming by a significant 1.83 per cent.

Data supplied by the funds themselves shows an average retail fund performance over 10 years at 3.80 per cent compared to not for profit funds at 5.63 per cent. The median return for all funds for the period was 5.42 per cent. The average retail return was some distance below the bottom quartile average return rate of 4.29 per cent.

The retail fund performance deficit of approximately 1.8 per cent has remain relatively consistent over time and may equate to the returns paid to shareholders of the for-profit fund providers or their related party service providers or other systemic issues.

The following table from Chant West shows the top performing funds for the 10 years to 30 June 2016.

¹⁵ SuperRatings' suite of Super, Pension, Sustainable, Risk Measure and CPI + Objective investment performance surveys for the period ended 30 September 2016

Table 1: Top 10 Performing Growth Funds* for 10 years to 30 June 2016 (%)

Ranking	Super fund and investment option	10 years (% each year)
1	REST Core	6.6%
2	QSuper Balanced	6.5%
3	BUSSQ Balanced Growth	6.4%
3	CareSuper Balanced	6.4%
4	Catholic Super Balanced (MySuper)	6.3%
4	UniSuper Balanced	6.3%
4	Commonwealth Bank Group Super Balanced	6.3%
5	Cbus Growth (Cbus Super)	6.2%
6	HOSTPLUS Balanced	6.1%
6	AustralianSuper Balanced	6.1%

Source: Chant West, 19 July 2016 media release (www.chantwest.com.au)

**Performance is net of investment fees and taxes. The returns in the table are before any administration fees or adviser commissions are deducted. The performance data is based on Chant West figures, and the table ranking is based on individual investment options offered by a superannuation fund, and the investment options involved in the ranking process look after assets worth \$1 billion or more.*

All the above long-term top performing funds have been selected as default funds within modern awards. It is recognised that over the short-term specific funds will exit and enter a top ten list.

5.2.2 Long-term return analysis – Chant West

Chant West's analysis of APRA's long-term return data over 24 years¹⁶ shows a real rate of return of 5.6¹⁷ per cent per annum for all funds which significantly overachieves the average return target ranges set by the funds themselves.

¹⁶ From July 1992.

¹⁷ Using APRA historical data we find that over a 24 year period an annualised return of 8.1% with an annual CPI increase of 2.5%.

5.2.3 MySuper analysis – SuperRatings

Work by SuperRatings¹⁸ also confirms that since the commencement of MySuper all the top 10 best performing funds are not for profit MySuper products which operate as default funds in modern awards. Importantly, when considering net returns to members, those products that are currently used as default funds under the existing default allocation arrangements are almost exclusively found in the top quartile of performing funds. This finding has remained relatively consistent over the short, medium and long-term; pre and post the introduction of the MySuper regime.

5.2.4 Performance of not for profit funds

The choice of higher performing default funds can make a real difference to Australian's retirement incomes.

If the SuperRatings average 10 year return data for not for profit funds of 5.63 per cent and the retail fund average return of 3.8 per cent is imported into the ASIC Money Smart superannuation calculator, using the same assumptions we find that a 30 year old earning \$100,000 per year, with a current superannuation balance of \$50,000 will on retirement at 67 receive \$113,984 or 27 per cent more if the default fund they are a member of is a not-for-profit fund.¹⁹

Those that argue that there is no support for persistence in returns for a particular product²⁰ must accept that as a class of funds, those funds that currently operate as default funds in modern awards, consistently outperform.

We note that cost structures that do not entail the payment of economic returns to shareholders and are therefore low cost, will as a class support improved performance. This supports the case

¹⁸ Source: SuperRatings, returns as of 31 August 2016.

¹⁹ Using ASIC's Money Smart Superannuation Calculator: Australian Securities & Investments Commission, (2016). *Superannuation calculator | ASIC's MoneySmart*. [online] www.moneysmart.gov.au. Available at: <http://tinyurl.com/z2dpjs4> [Accessed 28 Oct. 2016]. Calculations comparing 5.63% p.a. return to 3.80% p.a. return. All other assumptions the same. DOB 01/01/1986; income \$100,000 per annum; projected retirement age at 67; employer contribution at 9.5%, no additional contributions; \$50 p.a. administration fee; p.a. indirect cost ratio 0.6%; p.a. tax on earnings 7% and investment fees of 0.5% p.a. For full disclaimers and assumptions, go to www.moneysmart.gov.au.

²⁰ Minifie, J., Cameron, T. and Savage, J. (2014). *Super sting: how to stop Australians paying too much for superannuation*. Grattan Institute Report No. 2014 - 6, April 2014. [online] Melbourne: Grattan Institute. Available at: <http://tinyurl.com/gwcehxx> [Accessed 26 Oct. 2016].

for the selection of lower cost not-for-profit funds even when asset classes are subject to cyclical and structural fluctuations. We contend that not-for-profit funds have the sustainable advantages of low cost per asset class) and an undiluted focus on the interests of members.

What is clear, is that by any acceptable measure, those funds that are currently named as default funds within modern awards have on average outperformed over the short, medium and long-term. The continued outperformance of not for profit funds; which include industry, public sector and corporate funds; have vindicated their selection as default funds for employees

Changes to the default allocation system which could see banking institutions use their relationships with employers and new job starters to influence default fund selection towards lower performing funds operated in the best interests of shareholders, could see a significant reduction in member retirement outcomes.

The evidence is that the continuation of default arrangements is more likely to provide better outcomes for members.

6 Comments on Process for the development of alternative allocation models

The process identified on page six of the Issues Paper of firstly designing specific models; then assessing them against criteria to ‘fine-tune’ the models is, we suggest, a somewhat restrictive approach..

We suggest that the Commission’s deliberations should not commence with a predetermined model and end with its ‘fine-tuning’. Rather, it should be recognised that a vigorous application of objective and measurable criteria may result in anything from the fine-tuning of a model to allocate default fund members to the model being discarded as unworkable or inappropriate.

6.1 Principles for designing a model

The overriding principle guiding the design of a model for the allocation of employees to default funds must be members’ best interests. All decisions should be assessed against members’ best interests. Integrity, transparency, stability, sustainability, efficiency, competition, system-wide costs, fairness and equity are all sub-sets of members’ best interests.

The members’ best interests criteria must be elevated above any other criteria applied. It is of course recognised that other criteria are important and may have a significant impact on member interests.

Members’ best interests are not served if the superannuation and retirement system is not sustainable or lacks integrity, and consequently loses public and political support. The Issues Paper correctly recognises that the consideration of various criteria involves trade-offs. It is submitted that when considering the impact of a model, the criteria of members’ best interests should not be equally weighed against other criteria. These criteria should have primacy.

When considering members’ best interests, we suggest that real-life benefits to members, not theoretical considerations, should drive decision making. Relevant ‘real-life’ considerations could include, but not necessarily be limited to, possible implications of a particular model on net returns, insurance, fees and costs, stability, transparency, accountability and administrative efficiency.

6.2 Criteria for assessing alternative models

6.2.1 Members' best interests

The best interests of members should be classified as the primary criteria, the baseline against which other criteria are considered. The primary purpose of the superannuation system is to provide workers with a dignified retirement. The Government intends to introduce legislation that accepts the FSI's recommendation that the objective of superannuation is to provide income in retirement to substitute or supplement the Age Pension.

Members' best interests in the context of retirement savings is an objective that is measurable when assessing the needs of those who will be allocated to default funds.

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

We note that the Commissions' 2012 inquiry into default allocation methods recommended that: 'The primary principle governing default superannuation arrangements for modern awards should be the promotion of the best interests of employees.'²¹

We also include in the concept of members' best interests the provision of relevant and cost effective services to members. These services include insurance which is currently an integral part of default superannuation and a requirement of MySuper. We submit that there is a compelling case to provide default insurance as part of default superannuation, and that to run separate tenders for insurance (when this currently occurs in not-for-profit funds) will be materially disadvantageous to the majority of default members.

6.2.2 Competition

Competition that is based on metrics that objectively demonstrate that members' best interests are being served is supported. The establishment of appropriate qualifying filters is the most appropriate and cost effective mechanism to introduce competitive pressures on funds to be innovate and efficient.

Models that favour those funds that demonstrate the capacity to deliver superior long-term net returns and relevant cost effective services to their members should be preferred. Insofar as competitive pressures are further injected into the market, they will only be successful if these

²¹ Productivity Commission (2012), cited above, page 2.

pressures drive members into better performing funds. The metrics that apply to such considerations should focus on past long-term returns, asset allocation and reasonable return forecasts.

The introduction of competition does not necessarily deliver more efficient outcomes. Competition should be viewed as a means to deliver preferred outcomes, including efficiencies, not an end in itself. We make related comments elsewhere in this submission.

The FSI's final report accepted that Australia's superannuation market is unique:

*Australia's superannuation system is different from a traditional competitive market. Compulsory contributions, coupled by a complex system, contribute to disengaged consumers and weak member-driven competition.*²²

6.2.3 Integrity

Integrity as a criterion, described as the minimisation of opportunity for manipulation, the use of clear metrics and holding funds accountable, is supported. To ensure integrity and accountability there is a requirement for transparency of fees, behaviour, and reporting. Integrity implies good governance to protect the best interests of members and includes representation of members' and employers' interests on trustee boards.

Accountability is enhanced when there is a regular and sustainable process that requires funds eligible to receive default fund monies to earn their right to receive new default members, and ensures funds are accountable for the outcomes they deliver members. Integrity requires an open and transparent system that readily facilitates review.²³

²² Murray, D., Davis, K., Dunn, C., Hewson, C. and McNamee, B. (2014). *Financial System Inquiry Final Report*. November 2014. [online] Sydney: Commonwealth of Australia, p.105. Available at: <http://tinyurl.com/n7wl3lb> [Accessed 25 Oct. 2016].

²³ It should be noted that the existing default allocation process is transparent, open and the subject of judicial review.

6.2.4 Stability

Stability is an important factor within the superannuation system, both for members and government. The long-term horizons inherent within the superannuation system have benefited both fund members and the economy. Superannuation is a long-term investment and consequently there is a greater capacity for long-term investments.

Economic and individual good generated by the significant pool of long-term stable investment provided by the superannuation sector could be jeopardised if the Commission promotes change that could encourage short-term outlooks within the sector.

The stable and long-term outlook promoted by a long-term savings regime has delivered superior returns to members and any perceived benefits of a competition focused model should be considered against any negative impacts on long-term investment. It should be noted that the Commission recognised that the existing process for the allocation of members to default funds has provided stability to the market.²⁴

6.2.5 System-wide costs

A consideration of system-wide costs is important. However, the context should be a consideration of the net costs within superannuation and the retirement incomes system more generally.

The focus should be on a model's long-term impact on members and society and include the wider concept of sustainability of the superannuation and the retirement incomes system, including a reduction in reliance on the Age Pension.

The process of allocation of employees to default funds should be low-cost and easy to administer whilst minimising regulatory costs on industry, including business and employers.

²⁴ Productivity Commission (2012), cited above.

How should the principles and considerations in the terms of reference be operationalised? Are the Commission's proposed criteria suitable? What trade-offs might arise between criteria and how should these be handled?

Members' best interests should be the primary criteria. This is achieved through the selection of the best performing and most relevant default funds for employees.

The Commission is charged with considering the extent to which a competitive process can reduce reliance on the Age Pension. We agree with the Commission's view that the relevant section of the terms of reference should be interpreted to mean that the model should deliver competitive returns on members' balances, that members have access to a wide range of information and services, including advice, and that the allocation process does not create undue systemic risk.²⁵

We are concerned that if a model were chosen in which all default members were switched between funds when default status changed, this would create an unacceptably high level of systemic risk. We are also concerned that moves to separate members from funds which are associated with their industry or profession, which have provided sustainable long term returns, and which are well managed, will have dual consequences of removing difficult to obtain insurance cover (for some) and will further disengage members from their superannuation. Where an 'invisible hand' whether government or market is interposed between members and their fund, it is highly likely that their sense of control and trust will be dissipated.

What regulatory impediments to optimal competition might be relevant?

A key regulatory impediment to optimal competition is the lack of comparable data to facilitate fund comparison. It is suggested that ASIC's *Regulatory Guide 97: Disclosing fees and costs in PDSs and periodic statements* (RG 97) is the sub-optimal arrangements applying to non-MySuper products which have been exempted from certain disclosure requirements. A similar problem applies with inconsistent APRA product dashboard reporting requirements not equally applying to choice or non-MySuper products.

²⁵ Ibid, page 7.

Competition through comparability is not assisted with many funds providing web-based information that is not sufficiently transparent and clear to empower consumers to make an informed decision. Low levels of financial literacy and engagement highlight the need to resolve these barriers to informed decision making.

We are concerned the problem of direct and indirect inducements to employers is a clear market impediment. We note that this is a contentious subject where proof is often difficult to obtain. Commercial incentives and sales pressures have not been removed from the system. There is a need to examine evidence of principal-agent issues in default fund selection, including any possible direct or indirect incentives provided to employers. If a full member choice model eventuated, we would have even greater concerns about rewards for sales people, rather than members' best interests, guiding individuals into personal super accounts.

The survey work undertaken by Colmar Brunton on behalf of the ATO²⁶²⁷ provided evidence of influence on employer superannuation decision making, including the provision of incentives. The concern is not that banks offer superannuation products to individuals, but where banks offer packaged services to employers that involve business banking and default superannuation services to employees of the business.

A key, and it is suggested spurious, sales point to employers is the perceived advantages to the employer of a one-stop service. There is no legislative prohibition on an employer choosing a retail superannuation fund as their default fund solely because it is more convenient for the business. This convenience does not necessarily benefit the member of the fund chosen by the relevant employer. In fact, the evidence is where retail funds associated with banks are chosen by employers, the net returns to members of the relevant default funds are on average less and significantly less over time.

It is also suggested that whilst the offer of an inducement, say a discount of business banking rates, by the trustees of a fund is prohibited, it is not necessarily a contravention of s68A of the SIS Act for an employer to benefit from reduced rates that apply to bundled services. In fact it is

²⁶ Colmar Brunton, (2010). *Investigating Superannuation: Quantitative Investigation with Employers*. Final Quantitative Report prepared for Australian Taxation Office. [online] Canberra: Australian Taxation Office, pp.55-57. Available at: <http://tinyurl.com/m9go3ww> [Accessed 26 Oct. 2016].

²⁷ Colmar Brunton, (2010a). *Understanding Superannuation Preliminary Report: Qualitative Investigation with Employers, Consumers & Industry*. Prepared for Australian Taxation Office 25 March 2010. [online] Canberra: Australian Taxation Office, p.28. Available at: <http://tinyurl.com/hxto3jv> [Accessed 26 Oct. 2016].

suggested that it is common practice amongst banks for interest rate and other discounts and benefits to be increased where the business relationship is larger. In such circumstances, there is a clear incentive for an employer to include employee default superannuation arrangements in the transaction.

6.3 Designing the models

The Commission has identified three main steps in designing models:

1. Identifying which employees the model would cover;
2. Specifying a competitive process to determine which products are eligible to be used as defaults; and
3. Specifying how employees would be allocated to eligible default products.

Is this framework suitable for designing alternative models? What other steps might be necessary?

The premise of the Commission's question is that an alternative model should be designed. It is unclear what model the 'alternative' is to replace? Is it the existing system as currently operating, or is it the process introduced by the *Fair Work Amendment Act 2012* and as yet not implemented?

We concur with the Commission's view that the models will need to be workable. It is submitted that the worth of a prerequisite for a competitive process very much depends on the nature of any competitive process. Any desire for a competitive process should be driven by the ultimate consideration of what will be in members' best interests, not by any predetermined view on the theoretical benefits of competition.

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

We note that the current competitive model for the allocation of default funds is open to all complying funds; is transparent and applies a set of objective criteria. The as yet to be implemented process requires applicant funds to be assessed against each other, the process introduces and incorporates competitive pressure which requires funds to put their best foot forward in a formal application process that is akin to a transparent tendering process.

What lessons arise from models used in other countries and sectors? How applicable are these to Australia's superannuation system?

Whilst lessons can be learned from overseas models, considerable caution should be adopted when doing so. Australia's superannuation system is a component of an integrated retirement incomes system which is distinctly unique making comparisons very difficult.

There has been significant commentary regarding the role the introduction of the new²⁸ Chilean approved pension funds (AFP's²⁹) have played in reducing administration fees following the introducing of tendering for default fund status.³⁰

New members defaulted into an AFP cannot leave the fund for two years, which is the period that AFPs must tender for new contributing employees. Following a successful tender process, existing fund members have their fees reduced to the new level, a process that has seen steady fee reductions.

Much of the commentary has followed the publication of Report 2014-6 in April 2014 by the Grattan Institute entitled '*Super sting: how to stop Australians paying too much for superannuation*'.³¹ The report argues that investment management makes little difference to performance and that fee reductions can make a significant difference. The report suggests that default funds should be selected on a fee-based tender as per the Chilean system and that there should be a more active choice program through the ATO hosting a 'choice platform' which would compare the relevant individual's fund with the single default fund winner and facilitate a fund switch to the default fund.

It is suggested that a closer examination of the Chilean system raises a number of serious doubts that default tender arrangements would operate in the best interests of members.

²⁸ The Chilean government implemented a broad range of pension system reforms in 2008

²⁹ There are six *Administradora de Fondos de Pensiones* each offering five risk based investment options each charging the same administration fee.

³⁰ Minifie, Cameron and Savage (2014), cited above.

³¹ Minifie, Cameron and Savage (2014), cited above.

6.3.1 A closer examination of the Chilean system

In a recent report³² analysing the Chilean system Chant West concluded that: “A tender system may have relevance for Chile, but it is difficult to see what relevance it has for Australia given our very different structure and investment objectives and the depth of competition that already exists.” And “Overall, we believe MySuper fees compare favourably with default fees in Chile when the clear differences in the approach to investment management are taken into account.”³³

6.3.1.1 Fees not too high because of disengaged members

The Chant West report disagrees with the Grattan report claim that fees in Australia are too high because members are disengaged and fail to put pressure on funds to reduce fees. The Chant West paper accepts that members are disengaged but argues, that unlike Chile there is considerable pressure on funds to reduce fees given the vigorous competition between funds to attract and retain members. The Chant West report argues that the introduction of MySuper and the fee differentials within MySuper does represent an important point of difference as does the newly introduced requirements that funds must attest to their Boards, and potentially to APRA each year that their members are not disadvantaged as a result of the funds scale.

Chant West finds that, “clearly, there are enough funds with sufficient scale to generate vigorous competition.” And that this pressure is expected to grow with fund consolidation.³⁴

6.3.1.2 Market segmentation increases competition

The Chant West report cites market segmentation within the industry as a factor adding to an already competitive environment: “Broadly speaking, the industry can be divided into three groups of roughly equal size: for-profit retail funds, non-profit funds and self-managed funds. Each segment competes vigorously for members.”

6.3.1.3 Funds pressure service providers

There is clear evidence of a competitive environment benefiting members with healthy competition amongst service providers for the provision of a range of services in the superannuation industry. The Chant West report argues that funds:

³² Chant West, (2016). *Chilean Pension System August 2014 Relevance for Australia*. Research Report. [online] Sydney: Chant West. Available at: <http://tinyurl.com/zmc5mmm> [Accessed 26 Oct. 2016].

³³ Ibid, page 18.

³⁴ Ibid, page 12

*... put enormous pressure on the fees charged by their service providers – most importantly their administrators and investment managers. We see this in action constantly in the course of our consulting services, where we regularly conduct tenders on behalf of major funds and witness the competitive pressures first hand. The end result is that it is not necessary for members to put pressure on fees – their funds already do this for them and will continue to do so.*³⁵

6.3.1.4 Are the Chilean system's fees significantly lower?

The Grattan report's analysis that the Chilean pension systems fees are a third of MySuper default fund fees is incorrect. Incredibly the Grattan report only incorporates administration fees in the Chilean system and then compares this with the total of MySuper administration and investment fees. This is a major flaw in the Grattan report and for this reason alone the report's findings should be rejected.

Chant West analyses administration fees on a like-for-like basis and finds that they are broadly similar. The lower investment fee in Chile is explained by the different investment strategies found in the Chilean system, where unlike the Australian system, the Chilean investment strategy is focused on fixed income securities.³⁶ Importantly, this difference, partly explained by the short-termism introduced by the requirement to tender every two years; is reflected in lower returns to members in Chile.

In addition Chant West argues that the Chilean system is now uncompetitive as well as unsustainable.

The former Chilean Finance Minister, Andrés Velasco, now the Professor of Professional Practice in International Development at Columbia University has expressed a view that the tendering process in Chile has focused on administrative fees and not sought to ensure similar restraint on investment fees resulting in particularly poor outcomes for savers.³⁷

³⁵ Ibid, page 1

³⁶ Chant West estimate that 59% of Chilean pension funds are invested in fixed income securities compared to only 5% of MySuper funds.

³⁷ Velasco, A. (2016). Chile's Australian-style superannuation system feels the crunch. *Australian Financial Review*. [online] Available at: <http://tinyurl.com/hpxrdds> [Accessed 26 Oct. 2016].

Borzutzky and Hyde's³⁸ analysis of the Chilean pension system finds that many of the systems promises have not been delivered. They find the system has reduced coverage, reduced competition, delivered poor returns and reduced benefits, and has had a detrimental impact on low-income earners.

The reform promised an efficient pension market in which management charges, fees, and commissions would be determined by competition. However this promise, like many of the other promises made by the architects of the reform, has not been realised.³⁹

The new system in Chile has a long way to go before it matures sufficiently to be the subject of a robust analysis. What is becoming clearer is that the pressure of two yearly tenders has introduced short-termism that has impacted investment horizons, including a funds' ability to confidently invest in illiquid investments.

Fees do have an important impact on long-term returns and exercises that ensure fees are competitive are to be welcomed. Superannuation is a long-term investment and measures which will ultimately have a negative impact upon long-term net returns are to be avoided. Over the long-term; with Chilean funds showing a reduction in the ability or confidence required to invest for the long-term, it is suggested that returns from Chilean AFPs will not be as high as they otherwise would be.

Borzutzky and Hyde's investigations of the six largest AFPs shows "an inverse relationship between the degree of concentration in the pension fund management industry and its investment performance."⁴⁰

The difficulties in comparing Australia's methods of allocation to other countries is not to be underestimated.^{41,42} Issues which complicate comparison include the interface between the public

³⁸ Borzutzky, S. and Hyde, M. (2016). Chile's private pension system at 35: impact and lessons. *Journal of International and Comparative Social Policy*, [online] 32(1), pp.57-73. Available at: <http://tinyurl.com/zyogvs5> [Accessed 26 Oct. 2016].

³⁹ Ibid, page 61.

⁴⁰ Ibid, page 63.

⁴¹ Pascuzzo, P. (2015). *An International Comparison of Pension System Performance in Delivering Adequate Retirement Incomes*. Report by Patricia Pascuzzo, Super Research and Advisory, for Challenger Limited. [online] Challenger Limited. Available at: <http://tinyurl.com/zkms7hb> [Accessed 26 Oct. 2016].

funding and private savings, including the role taxation concessions play in the system. Critically, the objective of most retirement systems in the developed world differ and as a result the models for allocation of pension fund members differ.

The sustainability of the respective systems is a matter of national economic importance. The Australian retirement incomes system, whilst facing challenges with funding individual members' retirement adequacy, is regarded as one of the most sustainable systems in the world, in large part due to the public policy decision to defer wage payments into long-term superannuation savings. International examinations highlight the trade-off between retirement income replacement rates and fiscal sustainability; in most cases, one is purchased at the expense of the other.

6.3.1.5 Lessons from elsewhere

Perhaps even greater caution should be adopted when considering the merits of adopting regulatory structures and commercial practices in other industries such as banking, insurance, electricity or water.

There has been some commentary that the Commission may learn some valuable lessons from the deregulation of and competition in the Victorian energy market. We agree. We argue that these services are differentiated primarily by their pricing and the financial decisions surrounding choice of supplier. The choices available can be complex and require good information and high consumer search costs. As a consequence, very few consumers actively choose a provider.

In his paper *'If the retail energy market is competitive then is Lara Bingle a Russian cosmonaut?'*⁴³ Dr Ron Ben-David, Chairperson Essential Services Commission questioned the effectiveness of competition in the Victorian energy market.

Dr Ben-David argues that competition in the Victorian energy market has been driven by means and not ends and argues that an analysis of outcomes in the electricity market demonstrates that competition is weak and not delivering satisfactory outcomes.

⁴² Pascuzzo, P. (2014). *Asset Allocation of Pension Funds Around the World*. Mercer research for Financial Services Council February 2014. [online] Sydney: Financial Services Council. Available at: <http://tinyurl.com/jlf8my5> [Accessed 26 Oct. 2016].

⁴³ Ben-David, R. (2015). *If the retail energy market is competitive then is Lara Bingle a Russian cosmonaut?* Presentation to the NEM Future Forum 2015, 25 June 2015. [online] Melbourne: Essential Services Commission. Available at: <http://tinyurl.com/zhmgaau> [Accessed 26 Oct. 2016].

Dr Ben-David responds to those who cite the extensive new entrants into the Victorian energy market that there are in fact only six providers. The scores of other providers are in fact related parties of the six major competitors in the gas and electricity markets.

The paper argues that the criteria applied when testing the competitiveness of the energy market such as switching rates; barriers to entry; independent rivalry and product differentiation can lead to “ambiguous, and even contrary, conclusions about the competitiveness of the market. At best, they support a tentative conclusion about the existence of competition but they provide little (if any) insight into the vitality of that competition.”⁴⁴

Dr Ben-David states that:

*The economic weakness of the criteria is due to their focus on the ‘means’ rather than the ‘ends’. That is, competition is only ever a means for achieving the policy objective of market efficiency. Analysis ought to focus on whether the objective has been satisfied.*⁴⁵

We agree with Dr Ben-David’s comment that efficiency is the outcome sought:

*Nowhere other than in that policy paradigm is competition anything other than a means to an end. The end is always efficiency: the efficient allocation and use of society’s resources such that suppliers’ production decisions align with the preferences exercised by consumers, now and into the future — without deadweight losses or economic rents. Efficiency is, and must be, the outcome we seek. But competition is not synonymous with efficiency. Competition is a means. Efficiency is the end. Testing for signs of competition is not axiomatically equivalent to testing for efficiency.*⁴⁶

As with the superannuation market, there is a high level of consumer disengagement in the market. Despite large scale marketing campaigns encouraging consumer comparisons and switching only 13% of customers exercise choice.⁴⁷ Complex financial decisions are required to differentiate between the pricing alternatives offered by the various providers. Low levels of

⁴⁴ Ibid, page 2.

⁴⁵ Ibid, page 2.

⁴⁶ Ibid, page 23.

⁴⁷ After adjusting oft stated higher figures to accommodate consumers changing households.

financial literacy combined with inadequate information and search costs result in low active choice levels.

It is suggested that there are two primary reasons for this consumer inertia. The first is that all consumers will be receiving the same product, electrons and gas molecules and the second, that the product provided is, as Dr Ben-David suggests, a complex financial product that does not lend its self to active informed consumer choice. It is suggested that there are parallels with the superannuation market.

6.3.2 The Commission's proposed three step approach to designing models

6.3.2.1 Step 1. Identifying which employees the model would cover

The model should not limit itself to what the Commission describes as the 'flow on of new default members' or employees starting a new job who do not actively make a superannuation choice. The model should ensure that it caters for employees working multiple part-time jobs and those who have irregular employment patterns.

Which employees should be covered by the new default allocation model? Should any employee groups be exempt?

All employees eligible for Superannuation Guarantee payments who have not exercised choice of fund at a point in time when choice is offered to them, should be covered by a new default allocation model.

There are limited and decreasing numbers of members under defined benefit schemes or hybrid schemes that contain a defined benefit component, and we argue that the complexity and design of these schemes should exclude them from this change in defaults. Very few if any new members are now allocated to defined benefit schemes.

As the Commission points out there may be a case for excluding members of such schemes from any new allocation process. It is suggested that to not do so would undermine the viability of these schemes to the detriment of the fund and more importantly its members.

The discussion concerning who is eligible for superannuation contributions is a separate one to the model to allocate members to funds.

Should there be any flow on effects for existing default members from any new default

allocation model?

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

6.3.2.2 Step 2. Specifying a competitive process to determine which products are eligible to be used as defaults

What key services (or features) should be provided by default superannuation products? Should they all have to be MySuper products?

Whilst the financial best interests and other consumer protections contained within MySuper are supported, those protections in themselves do not offer sufficient protections that a strong default system driven by members' best interests can provide.

The Commission should not entertain any proposal that will allow non-MySuper products to be eligible as default products. MySuper products conform to a legislative schema which provides minimum yet important safeguards for superannuation members. Superannuation legislation, regulation and policy has been significantly changed and built around the core principles of MySuper. The primary principle being the operation of MySuper products in the best interests of members. Not all MySuper products need have the same characteristics, but they must meet the same minimum standards to be eligible to receive default fund monies.

If there is to be discussion regarding possible change to MySuper default arrangements, it should be over the MySuper standards and practices and not undermining the principle of a minimum benchmark that protects all members within default products.

Whilst there is a best financial interest requirement within MySuper, the MySuper default arrangements will allow for a wide variety of products with a range of service delivery objectives and net returns to members. The level of service and returns under MySuper is not subject to any minimum standards or otherwise prescribed, hence the increased need to ensure MySuper default funds named in modern awards are appropriate and provide higher end net returns and continuing services such as intra-fund advice to members. Table 1 demonstrates the clear outperformance of MySuper funds currently named as default funds in modern awards.

What are the advantages and disadvantages of allocating insurance through a separate

competitive process? What should be the key features of this default insurance product?

There are significant benefits surrounding the provision of insurance within superannuation. In particular group risk insurance within superannuation has proven to be cost effective for members and an efficient means through which members and their families receive protection. The provision of group insurance within superannuation ensures that millions of Australians and their families have a level of protection in the event of illness and death. In the absence of this coverage the Australian taxpayer would be outlaying billions to support injured superannuates and their families. Group insurance offered within superannuation provides highly affordable insurance with automatic acceptance being the norm.

Importantly the current default allocation process allows for the selection of funds that provide appropriate coverage for a particular demographic. Insurance coverage and cost is of significant importance to all employees and critical in certain industries.

Group insurance provides widespread insurance cover for most working Australians, and is particularly important for those groups of employees for whom insurance cover is difficult to obtain. The cover provided for miners, construction workers, emergency services employees and the like is often negotiated specifically with the insurance providers, and often with additional financial contributions from the employers. This cover is not only valuable, it is often irreplaceable, especially at a personal cover level.

The allocation of default funds must incorporate a process which facilitates market or occupation segmentation to ensure default funds in each industry or occupation incorporates relevant and cost effective insurance coverage.

6.3.2.2.1 Current default insurance requirements

In March 2013, the *Superannuation Legislation Amendment Regulation 2013 (No 1)* implemented amendments to the SIS Regulations and *Corporations Regulations 2001* which prohibited self-insurance and restricted the types of insurances that can be offered within superannuation. Importantly, the regulation also refines the minimum insurance requirements for default funds and MySuper members in regulation 9A of the *Superannuation Guarantee (Administration) Regulations 1993 (Cth)*.

Superannuation funds are required by section 68AA of the SIS Act to "provide", (rather than just offer), a minimum amount of death insurance for MySuper members on an opt-out basis. For a choice member, the minimum level of life insurance must only be "offered".

However, regulation 9.49 provides that life and TPD insurance must be offered on a compulsory basis for MySuper members, unless the trustee is reasonably satisfied the insurance cannot be placed with an insurer at a reasonable costs or it cannot be provided on an opt-out basis at all.

The superannuation industry is examining insurance arrangements to address issues and continue to ensure funds provide protection that meets members' needs at a reasonable cost, and that does not unduly erode retirement savings. This includes, amongst other things, an examination of the levels of cover, when cover is turned on and off, the cost of protection, data issues and the role and cost of competitive tenders in the industry.

Competitive tender processes within insurance are costly exercises and there is doubt that such processes have improved efficiencies or provided beneficial outcomes for members.

It is suggested that it is a key role of superannuation fund trustees to enter into insurance arrangements that are in their member's best interests. It should be noted that insurance arrangements are currently separate from members' accounts and the cost of default insurance is charged to the relevant account.

It is unclear why it would be desirable, or indeed possible to undertake a separate competitive tender process for insurance without undermining the benefits of group insurance.

There are potential conflicts of interest when a superannuation fund obtains insurance services from a related retail for profit entity. These are matters that do not influence the insurance decisions of not for profit funds.

What other considerations are relevant to specifying a competitive process?

Competition is not a good in itself; it is a means to an end and members' outcomes must be the decision drivers. As mentioned, one of the primary outcomes that should direct decision-making is the delivery of an adequate income in retirement to members. Competitive forces can be encapsulated within an administrative allocation model, they are not mutually exclusive.

6.3.2.3 Step 3. Specifying how employees would be allocated to eligible default products

Within a particular allocative model, should employees be segmented into groups for the purposes of allocating them to default products? If so, how should they be segmented? What are the benefits and costs of this approach?

It is appropriate to consider the different needs of members in various occupation and industries. It is recognised that there are varying demographics that are concentrated in particular industries and occupations. These may be different age or income cohorts or varying insurance or advice needs.

The existing model default allocation process is a segmented one which is intended to reflect the needs of varying industries and occupations.

Who should decide on which employees are allocated to which products, where multiple default products are chosen by the new allocative model?

It is appropriate that employers exercise choice of fund from within a range of eligible products. Whilst it is acknowledged that many employers do not have the skills or time or resources to choose from an extensive list of funds,⁴⁸ it is appropriate that employers select a fund that after transparent consideration has been deemed appropriate for the general industry or occupation that the employer operates within.

⁴⁸ Colmar Brunton (2010, 2010a) research, cited above. Previous employer submissions to the Commission and to Government have concentrated on employer concerns regarding search costs and information deficits.

Random choice exercises or allocation by age or occupation alone would require high quality data. The logic that flows from such an exercise is that an allocated fund would become less appropriate as a member ages or changes job. There is a danger of creating unsustainable cohorts, such as funds comprised of lower balance older members with no replacement cohorts, creating declining balance and member funds.

The system should assist employers by providing guidance regarding appropriate choice options. In Australia employers are not fiduciaries and the system must fill this gap by ensuring fiduciary type outcomes. Segmentation of eligible products for employers reduces employer search costs whilst providing better and more appropriate outcomes for members.

Models which are administratively efficient, provide quality, transparent and comparable information and have reference to integrity considerations are important considerations for those employers who seek the best outcomes for their employees.

7 Options for an allocation model

The Commission has proposed what it describes as three simple models and encourages participants to ‘think outside the box’ when proposing alternative models. We urge caution and remind the Commission that this exercise is not a theoretical one. Millions of Australians’ retirement incomes and the dignity of their retirement is likely to be affected by this exercise.

What other types of model, in addition to the three identified here, should the Commission consider in this inquiry?

An efficient hybrid model which adds competitive pressure within a framework that provides safeguards and filtering to specific member needs is a further option that may be considered.

The current default allocation process, together with the minimum MySuper standards, is a combination of what the Commission describes as an administrative model and a market based model. This is so because minimum standards are applied and considered in the context of a particular demographic of potential members. Public open submissions to an expert panel, which assess specific criteria, are a form of competitive tender.

7.1 Administrative model

What are the advantages and disadvantages of using some form of administrative filter to determine which products are eligible to be used as defaults?

- *What metrics should be used and how prescriptively should they be specified? Should the metrics be quantitative, qualitative or a mixture?*
- *Should there be a cap and/or floor on the number of qualifying products?*
- *How frequently should the process be run?*
- *Who should administer the selection and subsequent monitoring of products?*
- *What might be the role of MySuper in the long term under this approach?*

In any default allocation process, including an administrative one, the principal metric should be long-term net-returns and services to members. A range of other considerations would be relevant; these would include, but not be limited to:

- The long-term net returns delivered by the fund or its successor;

- The appropriateness of the fund's investment return target and risk profile;
- The fund's past and expected ability to deliver on its return target;
- Fees and costs charged;
- Insurance coverage and cost;
- Governance practices;
- Administrative efficiency;
- The availability and relevance of retirement income products;
- Member services, including information services; and
- The quality, availability and cost of advice.

The obligations on MySuper trustees to consider whether the relative scale of the fund is sufficient to provide products and services in the best financial interests of members has the potential to concentrate the default market. Our view is that the process of fund consolidation will continue, but that considerations of capital gains tax, equivalence of members' benefits, and the roles of the respective trustee offices can be significant and time consuming matters to resolve. With 115 MySuper products currently in the market it is anticipated that this number will continue to reduce. Work by Chant West has found that in their opinion there is considerable competitive tension amongst funds.⁴⁹ The existing default allocation process provides significant competitive tensions whilst also ensuring adequate filters based on member outcomes.

The review process could be run every three to five years, a period which would ensure a level of accountability and stability. The process should be administered by a government institution to ensure confidence in the system and regulatory control. It is further suggested that MySuper authorization should be the minimum, but not in itself sufficient, standard for eligibility to participate in the process.

We note that the above is consistent with the existing default allocation process.

⁴⁹ Chant West (2016), cited above.

What would be the likely effects of an administrative filter on competition between successful funds and in the superannuation system more broadly? What would be the implications for product innovation and system stability?

Competition and drivers encouraging product innovation can be built into a system whilst maintaining stability and minimising churn. The revised Fair Work Commission process can properly be described as one that is a competitive selection process which requires funds to put their best case in an open and transparent manner. This competition will encourage product innovation, but should not distract decision makers from the systems objectives, primarily the provision of adequate retirement incomes to members.

7.2 Allocation of members to products under an administrative model

What are the relative merits of using a single filter that covers the entire system versus a more segmented approach? What are the key practical considerations and challenges in implementing each approach?

A single filter provides for comparative assessment that would not otherwise be available. It should also be recognised that a single filter may incorporate a number of metrics, and ideally would be multi-dimensional. The existing default allocation process allows for a two stage process; the first applying single filters for metrics applicable to all funds and the second stage process is segmented to apply to occupations and industries the subject of the relevant modern award. This level of segmentation adds considerable value.

The existing default allocation process provides a considered balance between centralised and decentralised allocation methods.

In what ways could employees be allocated to eligible products in an administrative model? What are the advantages and disadvantages of each approach? What costs and responsibilities would fall on employees, employers, regulators and superannuation funds under each approach?

The Australian retirement incomes system accepts that there should be a publicly funded safety net for individuals in the shape of the Age Pension. Ultimately the costs and benefits of the success or failure of allocation processes are met directly or indirectly by all Australians, including

superannuation fund members. Concessional taxation arrangements ensure costs are incurred during the contribution period and if insufficient savings are made, or poor choices are made by individuals or on their behalf resulting in inadequate retirement savings, the taxpayer funds pension income replacement payments.

The public has a significant investment in and is impacted directly by retirement outcomes flowing from default allocation decisions. It is therefore appropriate that the public fund a process that ensures as far as possible appropriate outcomes.

An administrative model should be geared towards supporting employers and providing assistance to ensure employers meet their responsibilities and do so at a minimal cost. This involves the provision of information, contribution processing systems and guidance.

Employers have indicated that they prefer a level of guidance in selecting a default fund. An administrative model should reduce search costs and improve choice decisions through the provision of a range of choices. These limited choices should be relevant products for the employer which give the employer comfort that they can exercise choice without expending considerable time and expense whilst ensuring they are making a choice appropriate to their employees who do not exercise choice. Employers also value simplicity, and where they have effective processes in place, they generally do not see value in change.

Regulators play a role in ensuring minimum standards guide eligibility to participate in any administrative process. An example of this is the current requirement that a default fund is MySuper authorised.

Government has a role to ensure there is an appropriately resourced body to undertake the allocation process. There is currently a body charged with, and resourced for the task. The synergies and efficiencies flowing from the Fair Work Commission being charged with the administrative tasks of applying filters set by government are significant. The marginal additional cost of the FWC undertaking this task are minor. There is a compelling case for this task continuing to be undertaken by the FWC.

Changes in system design and technologies may impact the future roles and responsibilities within the system, including the role played by employers in the allocation process. These are matters that could be revisited in the future.

What should happen to default members in products that lose their approval under the filter?

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

7.3 Market based model

What would be the likely effects of a tender on competition between successful funds and in the superannuation system more broadly? What would be the implications for product innovation and system stability? What would be the likely effects on long term member outcomes?

The likely effects of a tender are unclear and would depend on the tender specifications, its scope and duration. Superannuation services cannot be equated to, for example, public transport tenders which may include penalty provisions that require compensation to members in the event that tender specifications or targets are not met. The risk is entirely borne by the superannuation fund member.

Australian taxpayers invest considerable amounts in our superannuation system. As taxpayers and fund members they should be confident that any tender process is open and transparent and free of conflict. Understandably, tender processes have a level of confidentiality associated with them. Unless the process is an open transparent one and is managed by a body that has the confidence of the public, any tender arrangements will undermine confidence in the superannuation system and reduce member engagement.

Superannuation is a long-term investment with the objective of maximizing retirement incomes. Tender processes are likely to encourage short-term considerations and measurements. For example, if fees and costs are the primary driver of a tender process, this will not necessarily equate to long-term returns.

Competitive tendering arrangements will encourage short-term investment decisions. Long-term investment decisions, such as investments in illiquid assets such as infrastructure, may deliver superior long-term returns. However, the uncertainty associated with regular tendering for eligibility to receive default contributions is likely to change investment decisions that would otherwise be made and possibly reduce long-term net returns to members.

Work undertaken by Mercer Research⁵⁰ found that, “the relatively immature Australian superannuation system means that the investment time horizon for most superannuation fund members (including many retirees) is at least 15 years”. The work also noted that, unlike some systems, Australia’s superannuation system does not require the conversion of lump sum payments to an annuity or pension benefit. As a result there is no need for members to de-risk their investments to protect them from market decline as they approach an annuity purchase date. This emphasises the importance of adopting allocation models which encourage long-term approaches.

The introduction of competitive tendering at any level will increase instability in the system. Instability encourages short-term decision making which is inconsistent with most decision making required within the superannuation system.

In his commentary *To tender or not: How Transparent is the process?* Professor David Hensher of The University of Sydney Business School⁵¹ questions the value of competitive tender processes on cost and outcomes. Professor Hensher questions the need to introduce competitive tendering uncertainties and costs in circumstances where the existing service provider is clearly doing a good job.

The level of instability introduced as a result of a tendering process will be a factor of the scope of a tender and the duration of any contractual arrangement that flows from a tender.

What metric(s) would be most appropriate to include in a tender, and why?

- *How should the bids be assessed against the metric(s)?*
- *Where there are multiple metrics, how should trade-offs among them be assessed?*

In any tender process the principle metric should be long-term net-returns and services to members. A range of other considerations would be relevant; these would include, but not be limited to:

- The long-term net returns delivered by the fund or its successor;

⁵⁰ Pascuzzo (2014), cited above, Page 16.

⁵¹ Hensher, D. (2015). To tender or not: how transparent is the process? [Commentary] *The University of Sydney Institute of Transport and Logistics Studies*. Available at: <http://tinyurl.com/hq4ezln> [Accessed 26 Oct. 2016].

- The appropriateness of the fund's investment return target and risk profile;
- The fund's past and expected ability to deliver on its return target;
- Fees and costs charged;
- Insurance coverage and cost;
- Governance practices;
- Administrative efficiency;
- The availability and relevance of retirement income products;
- Member services, including information services; and
- The quality, availability and cost of advice.

There will be trade-offs when considering various metrics. The methodology of assessing one metric against another is not an exact science, especially when returns are inherently variable from period to period and provider to provider and are difficult to predict. Considerations of risk and return; relevant insurance coverage and its cost; fees charged etc. will be impacted by a consideration of the demographic likely to be impacted by a default allocation choice. A single tender process will involve very different considerations to a tender applicable to a sub-set of employees such as construction workers where insurance cost and design is a matter of some significance.

Comparative metrics can only be properly applied if there is confidence in the consistency, comparability and accountability of data.

It should be noted that most of the above considerations are matters guiding the decisions of the Fair Work Commission Expert Panel which is charged with determining which funds are eligible to be listed on a Default Fund List to become eligible for consideration as a default fund for employees who are the subject of modern awards.

Consideration should be given to eligibility filters or criteria which may see a product become ineligible to participate in any default selection process if it consistently falls below a minimum return standard. The existence of multiple criteria would mean that judgment would continue to play a role. One such filter could apply to products for which returns fall within the 10 percentile range of returns over several rounds of tendering. For example, if the tendering rounds were every 4 years and after three successive rounds, or 12 years, a product was and had continued to be in the lowest 10 per cent of performers; it would become ineligible to further participate in tenders or default allocation processes until performance improved.

This process would only capture consistently poor performing funds. It is recognised that at some point the utility of such an arrangement would be diminished as return differentials would be reduced between the remaining more efficient or better performing funds.

It is also recognised that the regulators could play a similar role.

What scope might there be for funds to manipulate a tender process, and how can this be minimised? How might trials or experiments help in refining the design?

The benefit of using long-term net-returns (and judgment as to expected long-term net returns) as the critical consideration, is that it is not easy to manipulate. Short-term considerations should be avoided.

It is submitted that it is desirable to include multiple metrics in a tender process. It is conceded that this adds a layer of complexity, subjective judgment and cost. Factors that should be considered include insurance arrangements, advice services and the like.

The existing process for the allocation of default members is an open and transparent one that reduces the options for gaming and allows public discussion on the benefits of multiple metrics. The cost of such a process is significantly reduced as it operates within the existing architecture of the Fair Work Commission.

How frequently should a tender process be run? Who should administer the selection and subsequent monitoring of products?

One of the features criticised in the Chilean tendering process is the instability and investment short-termism introduced as a result of a requirement for 2 yearly tenders. Superannuation is a long-term investment and capital and investment decisions must be made with long-term horizons. A balance with the opportunity to review and introduce accountability is possibly a period between three to five years. We note the existing default allocation process contains a requirement for a comprehensive review every four years.

The process should be administered and monitored by a government authority.

7.3.1 Allocation of members under a market based model

What are the relative merits of using a single tender that covers the entire system versus a more

segmented approach? What are the key practical considerations and challenges in implementing each approach?

The clear benefit of a single tender is the reduced cost. The cost is likely to be borne by members who are placed in inappropriate funds. An allocation method that recognises demographic differences is to be preferred.

The existing default arrangements are a hybrid in which funds firstly meet MySuper criteria and then address specific general considerations to ensure their placement on a list of eligible funds. Thereafter a more segmented approach is adopted.

AIST does not support a single winner approach. A single winner approach would ultimately result in a significant concentration in the market, reduced competitive pressures and the possible introduction of a few similar and powerful players within the system.

In what ways could employees be allocated to eligible products in a market based model (including through single winner and multiple winner tenders)? What are the advantages and disadvantages of each approach? What costs and responsibilities would fall on employees, employers, regulators and superannuation funds under each approach?

There are of course multiple means by which employees could be allocated to eligible products via a market-based mechanism. We reiterate that any model for the allocation of employees to default fund products must be driven by the best interests of employees and concentrate on outcomes for members. Short-term considerations should not drive decision making. The inherent difficulty built into the Chilean tender system is the downward pressure on prices to a degree where quality investments cannot be sought, where member services are severely reduced, and the long-term viability of the fund is compromised.

Any market based allocation system should include multiple metrics and market segmentation to ensure members' best interests are accommodated. We consider it appropriate for a system in which members are legislatively required to save, and for which they receive a tax benefit, that a market based approach should be coordinated by a government institution to ensure a level of confidence in the system and regulatory compliance. Employers are not in a position to bear the significant search costs involved.

What are the merits of using the MySuper requirements as an entry threshold to the tender process? What are the potential problems with this kind of approach?

MySuper is the appropriate entry level for any default allocation process, including a tender. The MySuper regime is integrated into the Strong Super suite of reforms. To set aside MySuper would involve removing minimum entry standards designed to protect default members. MySuper provides a minimum standard but does not regulate fees or outcomes and as such the standard or operating filters should be higher.

7.4 Active choice by members

The Commission is correct to note that research on active choice models is scarce. To the extent that there is any, it is theoretical and bears no relationship to the Australian context. For choice to genuinely exist, it must be informed, consensual and free.

Choice is the opportunity or power to choose between two or more possibilities, or indeed the ability not to choose. The 'active choice' model as described in the Commission's Issues Paper may be more appropriately described as forced selection by employees. The term used in the Issues Paper to describe how this model would operate in practice is 'required' not 'choice'.

If a forced choice model is implemented the competition for members will be dominated by those funds that are vertically integrated with banks. A new entrant into the employment market will in most cases have only one relationship with a financial institution, their bank. This relationship is increasingly likely to be limited to a digital platform.

Influences on choice of superannuation fund in an environment where the employee is required to choose from a low or non-existent information base will inevitably focus on short-term considerations of convenience or brand recognition rather than competition based on long-term retirement income considerations.

It is entirely understandable that the primary focus of a 16 year old new entrant into the workforce will not be retirement incomes. In such an environment, convenience and short-term considerations and benefits will be promoted by suppliers. The new employees' focus will be on job related matters, including the possible opening of a new bank account to receive their first payments. It is at this point that a bank offering an integrated banking and superannuation platform is at a significant advantage. In such circumstances the disengaged consumer being required to choose a default fund will follow the more convenient path.

If a single portal for forced choice, similar to the Grattan Institute proposal, was introduced, it is likely that banking digital applications (apps) would provide a seamless link to a 'choice' portal.

The 2014 ANZ Survey of Adult Financial Literacy in Australia found a decrease in key financial literacy indicators which indicated a lack of financial sophistication and that this was more prominent amongst under 40 year olds. The survey also found a 'striking' increase in the use of online banking and related financial platforms, particularly amongst younger cohorts.⁵²

It is not surprising that a 16 year old with no experience, and perhaps little interest, in long-term net returns, will choose personal convenience and immediate benefits. The long-term cost of these forced choices, if they are inappropriate, will be borne not only by the individual, but all taxpayers.

Member engagement has increased but only as account balances become sizable and retirement looms. If active choice is to take place, this engagement needs to commence at the beginning of the accumulation process and continue thereafter. This is not happening and there are no indications of any improvement that could justify forcing choice in the hands of disengaged members or potential members.

Financial literacy surveys⁵³ demonstrate that financial literacy levels in Australia are low and not improving. The evidence is that far too many Australians are overwhelmed by financial decision making and ultimately do not actively choose. There is no social or economic good to be derived by forcing people to choose. The focus should be on addressing the underlying issues which impact on low engagement whilst simultaneously ensuring there are adequate protections for those that choose and those who do not.

Australia's financial literacy issues are particularly acute for those under 35 years. Any proposal to focus fund choice at the point where an employee first enters the job market will have a distorting impact on the superannuation market. Decisions in the best interests of new employees are long-term decisions. Thoughts of retirement incomes are not likely to be the drivers of decision making at this point. Nor are there any price signals that can be relied on that will be an indicator of likely long-term net returns.

⁵² The Social Research Centre, (2016). *ANZ Survey of Adult Financial Literacy in Australia (2014)*. Full report of the results from the 2014 ANZ survey, May 2015. [online] Melbourne: ANZ. Available at: <http://tinyurl.com/j4sy9hd> [Accessed 26 Oct. 2016].

⁵³ ASIC and EY Sweeney (2016), cited above.

The ABS's Adult Literacy and Life Skills Survey in 2006⁵⁴ found serious literacy and numeracy problems throughout Australia. Functional literacy levels were found to be at alarmingly low levels in areas with lower socio economic performance indicators such as education, income and employment. While this survey is slightly dated, all evidence indicates the situation has not changed. The Tasmanian estimated functional literacy rate of 51% in Tasmania has led to the adoption of a Tasmanian Adult Literacy Plan by the Tasmanian Department of Education. The factors resulting in the apparent persistence of low literacy rates in regional and rural Australia are similar to those impacting financial literacy.

Even if perfect or sufficient information did exist for consumers to make one of the most important financial decisions of their life, it is suggested that far too many Australians, particularly those in rural and regional areas are not sufficiently equipped or supported to make a choice of superannuation fund.

In their recent article *Competition as a means to an end: supply chains and human services*⁵⁵, Nicholas Gruen and Chris Vanstone discuss the difficulties of information asymmetry and the beneficial role regulation can play to assist consumer decision making.

“Asymmetric information between different players in the market – buyers, sellers and intended beneficiaries of services – corrupts the generation and flow of information about product quality and the various needs and circumstances of the players.”

It is suggested that an entry-level employee has limited information regarding which superannuation products would benefit them in the short let alone the long-term.

In his paper ‘Competition and Efficiency: Comment’ David Schwartzman argues that the logic of the competitive model and the argument for maximum technical efficiency under such a model is deficient in important respects; most notably the competitive models assumptions that easy entry and profit maximisation promote efficiency.⁵⁶

⁵⁴ Australian Bureau of Statistics, (2006). 4228.0 - *Adult Literacy and Life Skills Survey, Summary Results, Australia, 2006 (Reissue)*. [online] Canberra: Australian Bureau of Statistics. Available at: <http://tinyurl.com/gmkrvdq> [Accessed 26 Oct. 2016].

⁵⁵ Gruen, N. and Vanstone, C. (2016). Markets, supply chains, brains and human services. *Club Troppo*. [online] Available at: <http://tinyurl.com/hnho3gn> [Accessed 26 Oct. 2016]. Originally published at *The Mandarin* in two parts.

⁵⁶ Schwartzman, D. (1973). Competition and Efficiency: Comment. *Journal of Political Economy*, [online] 81(3), pp.756-764. Available at: <http://tinyurl.com/husx3a3> [Accessed 26 Oct. 2016].

7.4.1 Active choice with filter.

What are the advantages and disadvantages of an active choice model? How can these costs and benefits be assessed and measured?

Unless choice is informed and consensual it is suggested that an active choice model does little more than streamline the choice of fund process into a tick a box exercise under the guise of real choice.

An active choice with a filter has some clear benefits absent in a no filter model. The introduction of filters, ‘nudging’ or encouraging choice will not overcome the essential difficulty that the majority of employees do not and are unlikely to exercise choice. Even if active choice was forced by requiring employees to ‘choose’ a fund or limiting their choices, this will do no more than tick a box. Choice must be informed and consensual.

The work of Thaler and Sunstein⁵⁷ indicates that nudging (which can involve default rules), can encourage and assist members to make particular decisions or favoured outcomes. This ‘nudging’ strategy is reflected in the communication from superannuation funds to their members such as targeted information to particular demographics, say those approaching retirement. Thaler and Sunstein argue that there is no neutral design to nudging. Nudging is an attempt to steer people in a particular direction. Since the design of the nudge is conscious the choice-architect has the responsibility to anticipate human behaviour and the biases of the ‘nudger’ will be influence final choice.

The benefits of an active choice model are illusory unless those choosing make genuine and informed decisions that are in their best interests. The cost of choice errors are borne by both the individual and ultimately the taxpayer.

Active choice models are retail in nature and hence would be expected to have the highest cost compared to other models, which have a wholesale component. Additional fees arising from an increased administrative burden and from aggressive marketing activities are not in members’ best interests.

⁵⁷ Thaler, R. and Sunstein, C. (2008). *Nudge: Improving decisions about Health, Wealth and Happiness*. New Haven & London: Yale University Press.

What safeguard mechanisms might need to be put in place to deal with some of the potential pitfalls of an active choice model?

The active choice model is the option most capable of facilitating gaming. No safeguard would be capable of adequately dealing with the significant pitfalls associated with an active choice allocation process.

*Would an active choice model benefit from a filter to ensure good quality products are chosen?
What are the costs and benefits of government involvement in specifying a recommended list of products, compared to private sector provision of such information?*

A filter would not overcome the fundamental difficulty that an active choice model would operate in an environment where the vast bulk of employees would not actively choose a superannuation fund.

The costs of government involvement in specifying a recommended list of products would be minimal if the metrics were clear. Whilst private sector information services such as ratings agencies play a valuable role, it is suggested that the public confidence would be stronger in a government managed exercise.

*How can behavioural finance inform the development and refinement of an active choice model?
What experiments would need to be formulated and conducted to provide relevant evidence?*

Behavioural finance can potentially inform decisions regarding an active choice model. Behavioural finance shows us that consumers can often make what appear to be irrational or ill-informed financial decisions and that the tendency to do so is greater the more complex or long-term the available choices are. Behavioural finance provides a compelling case for regulatory protections for consumers in the superannuation market.

The framing of questions and the timing and context in which they are asked can make an enormous difference to decision making. The effective ‘nudges’ to elicit appropriate decision making will accordingly vary between individuals or at least demographic cohorts.

It is also important to recognise that the socio economic environment in which those decisions are made will also impact decision making and engagement. It is submitted that an 18 year old commencing work for a limited period prior to travelling overseas or commencing study will make default allocation decisions in a different context to a similar person seven years thereafter having completed their studies and commencing what they expect to be a long-term position.

Professor Cass R. Sunstein⁵⁸ of the Harvard Law School suggests that choice can be an extraordinary benefit or an immense burden. Sunstein suggests that in some contexts, people choose not to choose by choosing not to make decisions regarding health or retirement plans. Or would prefer to delegate those choices to a private or public institution that they trust (and may well be willing to pay a considerable amount for such delegations).

This point suggests that however well-accepted, the line between active choosing and paternalism is often illusory. When private or public institutions override people's desire not to choose, and insist on active choosing, they may well be behaving paternalistically.

Sunstein states that the ultimate judgment in favour of active choosing, or in favour of choosing not to choose, depends largely on the costs of decisions and the costs of errors.

Sunstein suggests that active defaults which direct people into appropriate choices have a role to play.⁵⁹ This would involve those failing to exercise choice being directed into an appropriate purchase. He cites commercial examples where this occurs where sellers use known data to direct appropriate purchases. Examples include the Book of the Month Club and tailored purchase nudges from online music streaming companies.

Fear and Pace's work on default superannuation arrangements argued that the principles of choice and compulsion sit uncomfortably together:

Choice of Fund was based on the assumption that consumers are interested in and able to make sensible decisions about their retirement. Compulsion, on the other hand, assumes

⁵⁸ Sunstein, C. (2014). *Choosing Not to Choose*. Harvard Public Law Working Paper No. 14-07. [online] Cambridge, MA: Harvard Law School. Available at: <http://tinyurl.com/js8mtwh> [Accessed 26 Oct. 2016]. See also Sunstein, C. (2015). *Choosing Not to Choose: Understanding the value of choice*. Oxford: Oxford University Press.

⁵⁹ Ibid, page 11.

*that most individuals need help to save adequately for retirement. What has been missing is a set of policy arrangements that promote the interests of disengaged consumers.*⁶⁰

The paper found that default arrangements are a highly effective policy option because they can improve financial outcomes for those who decline to make an active choice while retaining flexibility for those who want it.

⁶⁰ Fear, J. and Pace, G. (2008). *Choosing Not to Choose - Making superannuation work by default*. Discussion Paper 103, November 2008. [online] The Australia Institute and Industry Super Network. Available at: <http://tinyurl.com/hctnpe3> [Accessed 26 Oct. 2016].