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Submission – Superannuation: Alternative Default Models – Productivity Commission Draft Report

By David Bell

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***** The views expressed are solely those of the author and should not be assigned to any of the above-listed groups.*****

Summary

Productivity can come through two approaches, innovation and efficiency. While the two are often interrelated, they can be broadly considered exclusive for the purpose of this submission which focuses on the superannuation industry. The key theme of this submission is simple: when is the right time to focus on innovation versus efficiency, which focus is more appropriate given the state of maturity of the superannuation system, and what is the most appropriate timing for implementing efficiency measures?

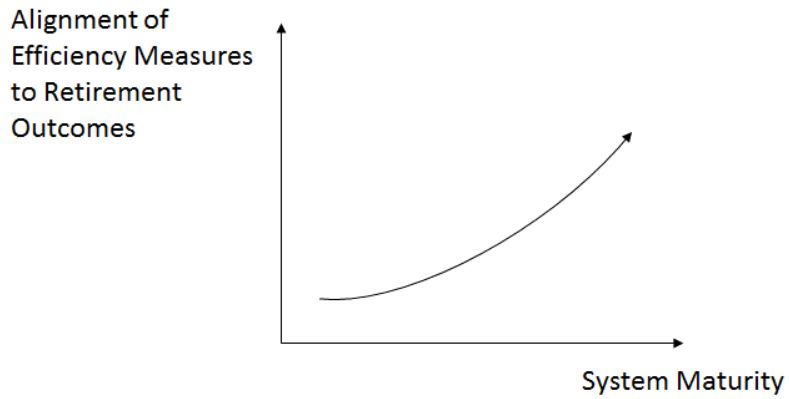
The Productivity Commission Stage 2 aims to enhance efficiency through the consideration of various alternative default model arrangements. The proposed default models attempt to simultaneously address two forms of system inefficiency:

1. Multiple superannuation accounts per member of the population;
2. An industry structure with too many super funds, resulting in high system-wide fixed costs and the ongoing survival of funds offering low value for money.

Both these issues are important, but do both need to be addressed at the same time through the same reform structure (alternative default model)? This implies some link between the two, and that the timing of their implementation needs to be aligned. I see no need for these two issues to be linked. In my view a solution to the account proliferation problem is a relatively straightforward and should be cleaned up as soon as possible. I detail an alternative default model proposal which addresses this problem.

However, the issues around a rationalised industry structure and enhanced model of competition are more complex. The crux of my challenge to the Productivity Commission's view of this problem is

one of system efficiency versus best retirement outcomes. While initially the two appear perfectly aligned, in reality there is only a partial alignment, the degree of which is conditional on the start date of any efficiency reform. I contend that the super industry is entering a final important stage of innovation, post which there will be a much greater alignment between efficiency and retirement outcomes.



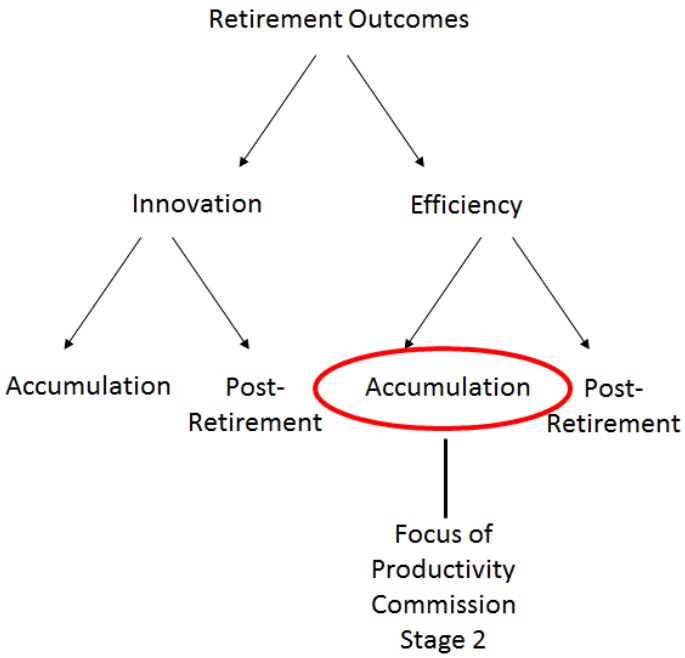
I contend that Stage 1 of the Productivity Commission failed to holistically frame the system-wide delivery of retirement outcomes. This statement is not intended to undermine the Stage 1 analysis undertaken by the Productivity Commission. However, the Productivity Commission risks recommending competition-based efficiency measures (as represented in Stage 2 Draft) which will most likely crimp the development of retirement outcome solutions at just the time when the industry is about to enter its most significant wave of innovation. There is a lot at stake – if this wave of innovation comes to fruition then Australia will have possibly the best retirement outcome system in the world and will be delivering good retirement outcomes for Australians.

Unfortunately, none of the 89 metrics in Stage 1 really capture the essence of what a good retirement outcome looks like; the Productivity Commission has not demonstrated how 89 metrics can be brought together into a holistic measure. In one respect the Stage 1 measurements are already outdated following the release of the Member's Default Utility Function version 1 (MDUF v1) which provides a framework for holistically capturing many of the important elements of retirement. This work was produced over 18 months by a 14-strong group of leading industry and academic researchers and is freely available to the public through the support of the joint custodians of this work, industry bodies AIST and ASFA.

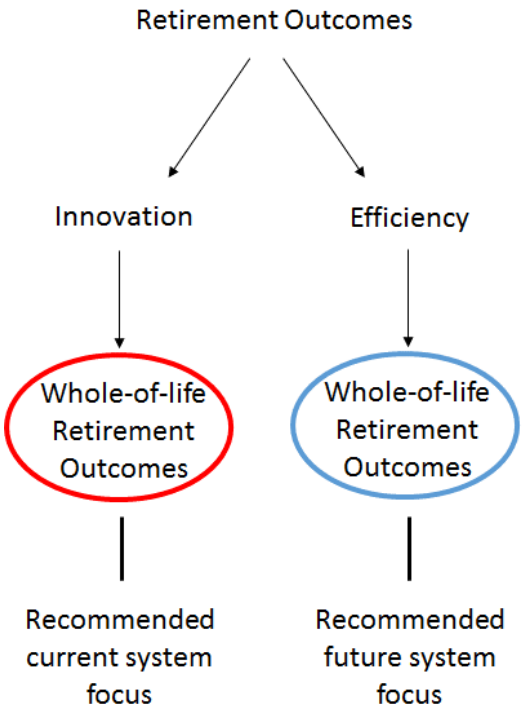
The opportunity cost of missing this next wave of innovation, which will complete Australia's retirement outcome system is significant. My initial analysis suggests that better retirement solutions provide a much greater uplift to retirement outcomes than cost reduction. Herein lies the problem:

1. Focusing on efficiency-based cost measures at this point in time may be permanently to the detriment of the development of innovative retirement solutions; whereas
2. Focusing on innovation allows the industry to reap a significant uplift in retirement outcomes bringing the industry to a level of maturity from which point it is then appropriate to focus on efficiency (i.e. the alignment between efficiency and retirement outcomes becomes stronger).

In short, the four default models proposed by the Productivity Commission target cost rather than directly target retirement outcomes. I view the Productivity Commission's Stage 2 focus in the following diagram:



I note in the framework above that the Productivity Commission distinguishes between accumulation and post-retirement. This is arguably for convenience; such a separation breaks down important linkages (risk, funding and legislative recognition) which will all impact on the quality of the retirement income system. The diagram below details my framing of an alternative focus which I believe will result in a better retirement outcome system:



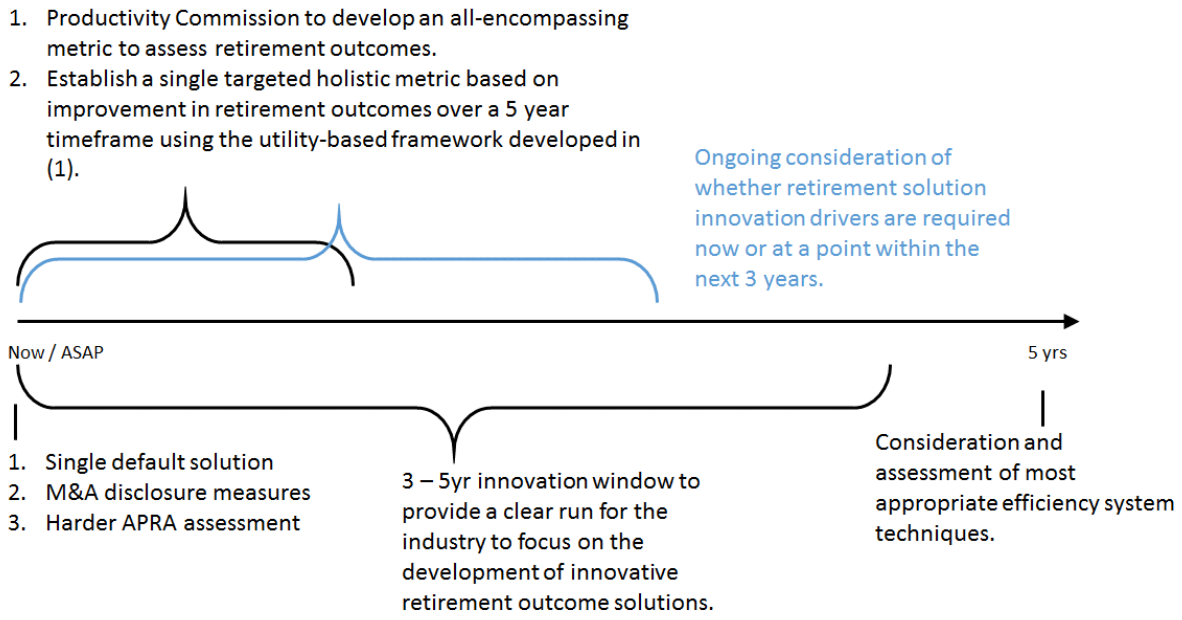
Can we begin to address the issue of industry structure / competition while this next, effectively final, wave of innovation is taking place? I believe the answer is yes. Instant implementation of the Stage 2 recommendations regarding M&A disclosure combined with a harder assessment approach by APRA regarding fund viability could easily lead to a sizable reduction in funds based on the criteria of scale, cost, quality of governance, and innovation towards retirement outcome solutions.

At some point a line must be drawn regarding retirement solution innovation. Progress has been frustratingly slow and there is a question mark around the true commitment, focus and ability of super funds to innovate – who is well positioned to develop leading retirement outcome solutions beyond Q Super, UniSuper, Mercer Super Trust and Mine Wealth + Wellbeing? The fault should not lay solely at the feet of super funds; constant industry reviews and the absence of a regulatory framework which allows the development of innovative retirement income solutions (currently being addressed by Treasury Laws Amendment (Innovative Superannuation Income Streams) Regulations 2017) has restricted innovation.

In summary I recommend the following 7 step process:

1. Measures, detailed in the body of this submission below, to remove the issue of account proliferation, unless it is an active choice;
2. To drive further consolidation based on the criteria of efficiency and potential to innovate, implement the recommended M&A disclosure combined with a directive for APRA to be harder in their assessment approach regarding fund viability;
3. Further research by the Productivity Commission to develop an all-encompassing metric, based on a framework similar to that detailed in MDUF v1. This is to ensure a better understanding of system-wide retirement outcomes and the optimal time to implement efficiency-based techniques;
4. Establish a single targeted holistic metric based on improvement in retirement outcomes over a 5-year timeframe using the utility-based framework developed in (3);
5. A three to five-year innovation window to provide a clear run for the industry to focus on the development of innovative retirement outcome solutions;
6. Consideration of whether retirement solution innovation drivers are required now or at a point within the next 3 years (examples of retirement solution innovation drivers are detailed in the body of this submission);
7. At an appropriate point of maturity, anticipated to be no more than 5 years, consideration of techniques to drive system efficiency.

The timeline for these recommendations is detailed below:



Introduction

There is clearly no need for 50 super funds let alone 220. There are agents galore, most of them well intentioned; but good intentions are not enough: Australians deserve quality retirement outcome solutions delivered efficiently. While the superannuation system is not as efficient as it could be, neither has the system reached a level of maturity whereby it is well positioned to meet the retirement outcome challenge, namely delivering sustainable retirement outcomes which account for investment and mortality risk.

Therein lies a threshold question: at what stage is it appropriate to implement competition-based efficiency measures? Should this type of industry intervention occur before, during or after an industry has reached an appropriate point of maturity?

A second threshold issue of significant importance relates to how one views the superannuation industry when considering efficiency-based reforms.

It appears that for reasons of convenience the Productivity Commission has effectively separated the accumulation and drawdown aspects of the superannuation industry, enabling a more direct focus on fees and overall efficiency. What cost this separation? If it contributes to a slower rate of development or a ceiling on the quality of retirement outcome solutions then I argue that the opportunity cost is very high.

The fact that no person or group, including the Productivity Commission, has estimated the lifecycle outcome welfare benefits of quality retirement outcome solutions self-identifies this industry as immature. Frustration at this slow pace of reaching maturity (after all this year represents the 25th anniversary of the Superannuation Guarantee) needs to be put aside if the upside is large enough (which I believe, and hopefully display that, it is).

The recent release of the Member's Default Utility Function version 1 (MDUF v1) is brought to the attention of the Productivity Commission. It captures a sensible set of preferences for what someone would want in retirement and represents them in the form of a utility function. This work

is freely available for all in the industry to use. This could also be a framework for the Productivity Commission to consider.

Stage 2 introduces four alternative models which are expected to perform better than the existing default arrangements. This consideration is through an accumulation-only lens. I believe that a broader whole-of-life system outcome may be lower because of the opportunity costs of loss of engagement and the non-development of innovative post-retirement solutions which integrate with the accumulation stage. I detail an alternative One-Default Fund per Member model which I believe has the potential to offer superior system-wide lifecycle outcomes. I believe that some efficiency gains can be achieved using simpler approaches (e.g. APRA could be harder in their assessment approach regarding fund viability). I believe that a focus on pure efficiency measures can be implemented once a number of hurdles for improved retirement outcomes have been achieved (i.e. the system has reached an appropriate degree of maturity).

The models proposed for Stage 2 and the criteria used to select default funds appear somewhat philosophically inconsistent with the measures of efficiency detailed in Stage 1. They introduce potentially dangerous operating motives for super funds. The focus on primarily quantitative backwards looking measures does not prepare the system for the future challenges posed by investment markets.

Reflections on Productivity Commission Stage 1

Productivity Commission Stage 1 was eminently sensible in that it acknowledges that there are many aspects of product and service value delivered by the superannuation industry. This results in a large number of metrics, 89 in all. Ultimately the Productivity Commission was unable to bring all these components together to holistically frame the system-wide delivery of retirement outcomes. As such it is left with a balanced scorecard type of approach. At this point it appears that the Productivity Commission is unable to clearly trade off the value of different metrics.

Without an all-encompassing measure the Productivity Commission risks recommending competition-based efficiency measures (as represented in Stage 2 Draft) which will most likely crimp the development of retirement outcome solutions at just the time when the industry is about to enter into its most significant wave of innovation.

In some respect the Stage 1 balanced scorecard approach (not the measurements themselves) are superseded following the release of the Member's Default Utility Function version 1 (MDUF v1), which provides a framework for holistically capturing many of the important elements of retirement (I note the release of MDUF v1 was after the completion of Stage 1). This work was produced over 18 months by a group of 14 leading industry and academic researchers and is freely available to the public through the support of the joint custodians of this work, industry bodies AIST and ASFA.

The introductory paper to MDUF v1 is included here (http://www.aist.asn.au/media/973909/an_introduction_to_mduf_v1.pdf). Further papers, models etc, can be found at http://www.aist.asn.au/policy/member%E2%80%99s-default-utility-function-(mduf).aspx (ASFA will also be hosting this work on their website soon). In short MDUF v1 utilises a utility framework enabling multiple criteria to be captured in a single (utility) score. This technique has been used by academic researchers to address retirement outcome problems for nearly 50 years. MDUF v1 specifically captures the following preferences:

1. People prefer a higher income in retirement;
2. People prefer a smooth income in retirement;
3. Outliving retirement savings (or retirement income stream) is a bad outcome;
4. People are risk averse;
5. People place some value on a residual benefit at death.

It is illuminating to consider how this framework compares against some of the criteria outlined by the Productivity Commission in Stage 1. For instance:

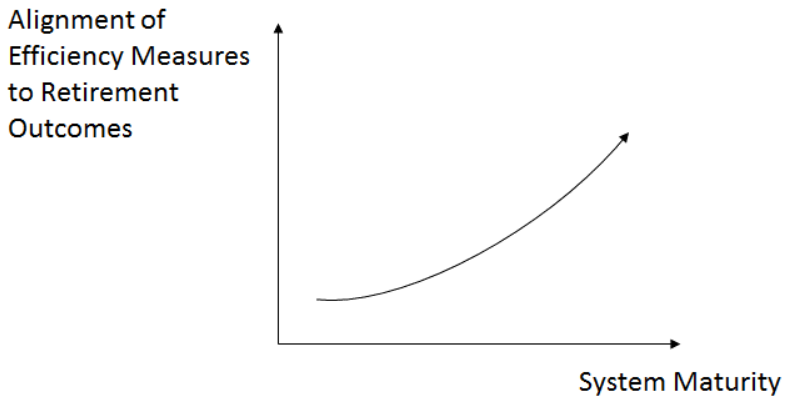
- An efficiency gain will be captured by MDUF v1 (in the form of higher net investment returns);
- Stage 1 measures do not quantitatively assess the range of possible retirement outcomes which emanate from different retirement solutions, effectively ignoring features (2), (3), (4) and (5) above;
- The benefits of risk reduction are explicitly valued by MDUF v1 but only serve as an additional metric (risk-adjusted returns) in Stage 1.

I believe there would be great benefit to the Productivity Commission to spend 12 – 18 months developing a more holistic framework for assessing the delivery of retirement outcomes, based on something similar to MDUF v1. In effect this would form a superior foundation of any analysis and recommendations. From here the Productivity Commission could determine a single targeted holistic metric based on improvement in retirement outcomes over a 5-year timeframe using the utility-based framework developed.

Reflections on Productivity Commission Stage 2

Productivity can come through two approaches, innovation and efficiency. While the two are often interrelated, they can be broadly considered exclusive for the purpose of this submission which focuses on the superannuation industry. The key theme of this submission is simple: when is the right time to focus on innovation versus efficiency, which focus is most appropriate given the state of maturity of the superannuation system, and what is the most appropriate timing for implementing efficiency measures?

The crux of my challenge to the Productivity Commission's view of this problem is one of system efficiency versus best retirement outcomes. While initially the two appear perfectly aligned, in reality there is only a partial alignment, the degree of which is conditional on the start date of any efficiency reform. I contend that the super industry is entering a final important stage of innovation, post which there will be a much greater alignment between efficiency and retirement outcomes.



In the body of this submission I attempt to provide some estimates of the uplift in retirement outcomes from successful innovation. I believe these far outsize potential efficiency gains. I contend that implementing the proposed alternative default models now will inhibit the realisation of these innovation benefits.

The Productivity Commission Stage 2 aims to enhance efficiency through the consideration of various alternative default model arrangements. The proposed default models attempt to simultaneously address two forms of system inefficiency:

1. Multiple superannuation accounts per member of the population;
2. An industry structure with too many super funds, resulting in high system-wide fixed costs and the ongoing survival of funds offering low value for money.

Both these issues are important, but do both need to be addressed at the same time through the same reform structure (alternative default model)? This implies some link between the two, and that the timing of their implementation needs to be aligned. I see no need for these two issues to be linked. In my view a solution to the account proliferation problem is relatively straightforward and should be cleaned up as soon as possible. I detail an alternative default model proposal which addresses this problem.

Further reflections on Stage 2, addressed in the body of this submission, can be collected in three broad themes:

1. Is it appropriate to separate the accumulation phase from the post-retirement phase? I believe that this is a separation for convenience rather than one of merit.
2. An alternative default model for dealing with account proliferation along with justification for no changes to the current default award process (based on inhibited innovation, appropriate insurance, and broken engagement models).
3. The dangers inherent in the reduced backwards-looking assessment focus (compared to the criteria outlined in Stage 1).

I endorse the proposed M&A disclosures and the need to reduce account proliferation.

Finally I produce a set of recommendations along with implementation timelines.

Sizing the Benefits of Future Innovation

In this submission I flag my support for the merits of innovation versus efficiency at this point in time for the superannuation industry given its current level of maturity.

How can we size the benefits of future innovation? First we require an all-encompassing measure of retirement outcomes. I have been part of a group which has developed this: MDUF v1. The case study undertaken in the MDUF materials (http://www.aist.asn.au/media/973927/technical_paper_3_mduf_v1___optimal_dynamic_strategies.pdf) provides an initial estimate of the benefit of appropriately designing a dynamic retirement outcome solution which efficiently utilises three sources of retirement income (account-based pension, life annuity and age pension). The uplift in risk-free annual returns through retirement required to match this benefit is estimated to be 68bps.

What innovations are captured in this calculation?

- Tailored solution for the individual based on known characteristics (age, balance and gender)
- Dynamic rebalancing of consumption and investment strategy

What innovations are not captured in this measurement?

- Tailored to personal characteristics (other relevant information);
- Tailored to personal preferences (e.g. different degrees of risk aversion);
- A broader range of retirement income solutions (e.g. deferred annuities, group-self-annuitisation structures etc.);
- Using this technology to improve engagement and financial planning.

With these innovations incorporated it is reasonable to suggest that the uplift in risk-free annual returns through retirement required to match these benefits would be around 1% pa (further detail will likely be included in CIPR submissions). This amount far exceeds the amount the Productivity Commission could realistically expect to achieve from its efficiency measures. However, it needs to be noted that the Productivity Commission's efficiency benefits would apply through whole-of-life not just through post-retirement so should be scaled up.

The risk, as explained previously, is that the focus on efficiency may mean that the exciting wave of innovation planned that could be unveiled over the next 3 – 5 years is never implemented or implemented in reduced form (with reduced benefits).

Whole-of-life or Separate Accumulation and Post-Retirement?

In Stage 2 the Productivity Commission specifically focuses on the accumulation phase for their efficiency measures. Is it appropriate to separate the accumulation phase from the post-retirement phase? I believe that this is a separation for convenience rather than one of merit.

Three examples highlight the connections between accumulation and drawdown, thereby highlighting the need for a whole-of-life focus:

1. Risk: Risks to the drawdown phase can often be hedged with accumulation assets. An example is annuity purchase price risk (detailed in many textbooks and academic papers). The purchase (full or part) of a life annuity at retirement represents a substantial investment in a long-dated fixed income security. Effectively there is a large single point of risk event, namely the yield of the annuity / benchmark fixed income security at the time of retirement.

To hedge this risk one can ladder into longer-dated bonds during the later years of the accumulation phase. This is one of the justifications of a lifecycle strategy. This example also highlights how one super fund's accumulation strategy may not mix well with another fund's post-retirement strategy.

2. Funding: For many funds the percentage (by number of people and by assets) in post-retirement versus accumulation is small. The Productivity Commission's focus on accumulation efficiency may contribute to a silo focus within super funds. Specifically funding for post-retirement solution design most likely needs to be subsidised by accumulation assets (which is acceptable as they will ultimately benefit from this research). A focus on accumulation efficiency may mean less spent on post-retirement solutions, hence inferior retirement outcomes.

3. Legislative recognition: Through Treasury Laws Amendment (Innovative Superannuation Income Streams) Regulations 2017 there exists legislative recognition that connects post-retirement solutions into the accumulation phase. The Amendment specifically allows for retirement income stream solutions which are purchased during the accumulation phase (typically on a staggered basis). This extends the accumulation phase far beyond the relatively simple (existing) accumulation account concept which would support the Productivity Commission's view of separating the accumulation and post-retirement stages. Leading practice retirement solutions of the future are most likely to be designed from a whole-of-life perspective.

While it could be argued that Treasury's current work on Comprehensive Income Products for Retirement (CIPR) will address the post-retirement phase there are many uncertainties surrounding CIPR (to be addressed in a separate submission). At a high level these include:

- Clash of ideologies – in my estimation policymakers (represented by Treasury) have different preferences to the preferences of the population;
- System cost vs. system benefit – the system benefit may only be modest relative to the system-wide cost;
- Is the industry good enough? Are there enough super funds with the skills and resources to produce quality CIPR solutions;
- Glass ceiling effect – funds may think they have met the retirement outcome challenge by developing a CIPR; in my view they have only made a modest step.

Proposed One-Default Fund per Member Model

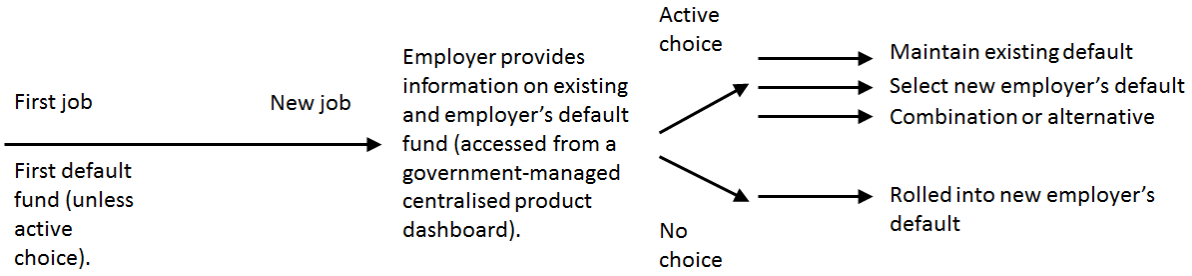
The four alternative models proposed by the Productivity Commission Stage 2 appear to address two separate problems with one solution:

1. Multiple superannuation accounts per member of the population;
2. An industry structure with too many super funds, resulting in high system-wide fixed costs and the ongoing survival of funds offering low value for money.

Account proliferation is a problem which needs to be cleaned up. To address this I propose an alternative default model – the One-Default per Member Model. I propose that it would work as follows:

1. An individual only has one super fund unless they make an active decision to have multiple funds;
2. As an individual changes jobs / industries they are prompted to choose between their existing fund and their new employer's default fund. I recommend no change (at current time) to the existing processes of selecting default funds (reasons discussed in further detail below);
3. The individual will be provided with comparisons of the two funds (carryover and employer default) via the employer's access to a government-managed centralised product dashboard which allows easy access for companies and individuals;
4. If the individual makes no choice their existing default fund is rolled into the company's default fund.

This proposed process is summarised in the diagram below:



The most obvious question emanating from this proposal is why roll into the new employer's default fund as the default action?

1. I am unconvinced that the criteria for selecting defaults under any of the four proposed models will result in better retirement outcomes – this is the major theme of this submission (innovation versus efficiency, system maturity, and the appropriate timing of efficiency measures).

2. Targeted insurance solutions – though the Productivity Commission has removed this as a criteria, no strong case is made for this removal. Insurance down industry lines can often be better facilitated by specialist super funds.

3. Engagement model – for employees in many industries and companies the default super fund provides core financial literacy and superannuation engagement services. This model is effective – a good example is the member pit talks undertaken by the fund I work for (Mine Wealth + Wellbeing).

   All four alternative default models proposed in Stage 2 break down this engagement model – in effect there could exist multiple cohorts of employees with different superannuation funds, resulting in scattered memberships which are uneconomical for any represented super fund to visit.

Financial literacy is highlighted as important in Stage 1 but then put to the side in Stage 2. What are the costs of reduced financial literacy? This is a difficult question to answer. US academic researchers Annamaria Lusardi and Olivia Mitchell are recognised as global leaders in financial literacy. The picture from their research is disturbing: those with low levels of financial literacy have a greater likelihood of making financial mistakes, including being misled or defrauded. On the other hand those with higher financial literacy undertake sensible actions such as creating diversified portfolios, maintaining a precautionary savings pool and planning for retirement. Those with lower financial literacy levels commonly experienced higher costs for financial transactions and higher rates for loan products.

Dangers Inherent in a Fees / Past Return Focus

The four alternative models are based on a reduced set of criteria which mainly focuses on fees and past returns. The recognition of a broader set of criteria and the incorporation of discretionary judgement detailed in Stage 1 are largely put aside in Stage 2. This narrower focus increases the risk that the industry will collectively fail to meet some of the large investment challenges while also entrenching a peer group oriented mindset.

From an investment management perspective the two greatest objective (as opposed to subjective) portfolio risks that exist today (from my perspective) are:

1. High risk portfolios are dominated by exposure to equity risk premia;
2. Lower risk portfolios are dominated by fixed income which has a very low real expected return.

The solution to both problems realistically involves greater diversification into assets which most likely will cost more than traditional bonds and stocks. To meet a future problem the best course of action for a fund would be to diversify more (creating peer group risk) and increase fees. This is a difficult decision for funds to take when viewed through the lens of the alternative default criteria outlined by the Productivity Commission in its proposed alternative default models.

Under the proposed criteria there will also be a bias to 'lock in' any outperformance and realise the business benefits of strong past performance, possibly to the detriment of future performance.

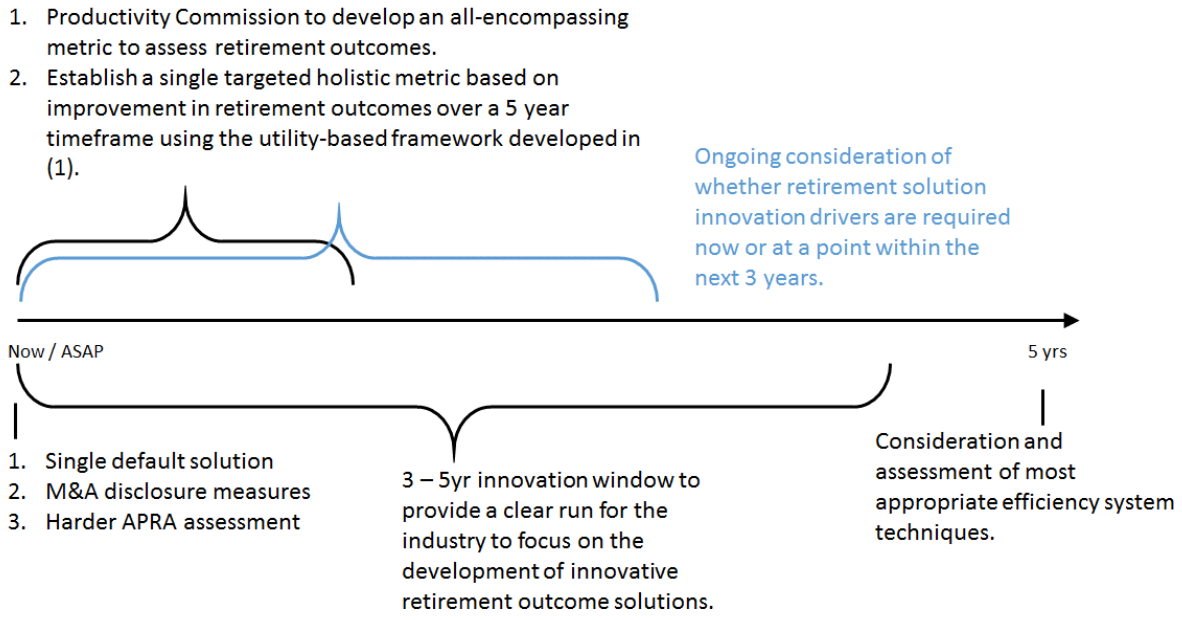
Recommendations

Ultimately I find myself philosophically opposed to many of the Stage 2 proposals of the Productivity Commission. In my view the Productivity Commission focuses on efficiency to the detriment of innovation, innovation that may never be realised if the proposed efficiency measures are implemented. Now is the time to give a positive message to the industry that they have a period of time to go forth and innovate and lift this system to its potential. This is not an indefinite period of time and if the industry doesn't become more efficient in the meantime then measures will be taken. In summary I recommend the following 7 step process:

1. Measures, detailed in the body of this submission, to remove the issue of account proliferation, unless it is an active choice;

2. To drive further consolidation based on the criteria of efficiency and potential to innovate, implement the recommended M&A disclosure combined with a directive for APRA to be harder in their assessment approach regarding fund viability;
3. Further research by the Productivity Commission to develop an all-encompassing metric, based on a framework similar to that detailed in MDUF v1. This is to ensure a better understanding of system-wide retirement outcomes and the optimal time to implement efficiency-based techniques;
4. Establish a single targeted holistic metric based on improvement in retirement outcomes over a 5-year timeframe using the utility-based framework developed in (3);
5. A three to five-year innovation window to provide a clear run for the industry to focus on the development of innovative retirement outcome solutions;
6. Consideration of whether retirement solution innovation drivers are required now or at a point within the next 3 years (examples of retirement solution innovation drivers are detailed in the body of this submission);
7. At an appropriate point of maturity, anticipated to be no more than 5 years, consideration of techniques to drive system efficiency.

The timeline for these recommendations is detailed below:



Retirement Solution Innovation Drivers

The concept of some retirement solution innovation drivers is considered in the recommended 7 step process. Here I provide two examples of innovation drivers:

<u>Example 1 – Soft driver: industry measure and target.</u>

A measure such as MDUF v1 is used as the assessment tool for retirement outcome solutions (using fund's own input assumptions regarding market returns etc). A percentage improvement in retirement outcomes over a specified timeframe (e.g. x % over y years) is communicated to super funds by Productivity Commission / APRA. Funds must display to APRA how this objective will be

achieved. This has the impact of cleaning out those funds who cannot undertake the requisite complex modelling.

Example 2 – Hard driver: win back your retired members.

A centralised retirement outcome solution is created and managed by a government agency. Super funds which have not obtained a sufficiently high standard of retirement outcome solution will have their retirees defaulted into this pool under a white-label arrangement. The super fund then has a period of time (e.g. z years) to obtain the standard otherwise those members are lost forever (i.e. the white labelling arrangements unwind). Note that these members typically have much larger balances than new workers (the target of the Stage 2 alternative default models) and so the impact on fund rationalisation is likely to be more substantial.