

CIFR Submission to Productivity Commission¹

Superannuation: Alternative Default Models

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Superannuation: Alternative Default Models

The Centre for International Finance and Regulation (CIFR) welcomes the opportunity to provide input to the Productivity Commission (PC) inquiry into alternative default models for the superannuation industry. This submission makes a few points, but they are vital:

1. The entity that has the responsibility for selecting and monitoring the default provider should be the prime focus, rather than the mechanism by which providers or products² are chosen. *Who* chooses matters most; and *how* they choose should not be dictated by public policy.
2. Member heterogeneity makes it important to accommodate the ability to tailor, and foster the development of smarter defaults.
3. Market-based mechanisms involving an open tender or auction to manage superannuation for broad cohorts of default members may lead to inefficient outcomes that are at odds with member needs.
4. It is recommended that a new class of private sector entity be established – *member agents* – that are responsible for the selection and monitoring of default providers. This approach will drive competition from the grass roots in a way that accords with member needs.

The submission draws on CIFR research into MySuper undertaken over the course of the last three years, specifically projects SUP002³ and TSUP⁴ which examine the MySuper regime, including the design of MySuper products and the extent to which they accord with the wants and needs of members.

The Framing is Off-Cue

“The public inquiry will examine alternative models for a formal competitive process for allocating default fund members to products.” (Productivity Commission website)

The above statement encapsulates the objective of the inquiry. This objective arises from the terms of reference provided by the Government. The latter takes its lead from the Financial System Inquiry (FSI),⁵ and asks the PC to consider ‘auction, tender and other types of competitive process’ for the allocation of default members. The PC has stated that it is adopting a ‘no defaults’ baseline, i.e. starting from a blank sheet of paper. However, the discussion appearing in the PC’s Issues Paper, and the framing of the terms of reference, seem to imply certain expectations about the type of solution that is to be contemplated: some form of market-based solution⁶ by which default members are allocated to providers or products will be mandated as a matter of policy. The terms of reference also seem to imply that this will probably involve competitive bidding by providers for the right to direct default contributions or perhaps even balances into their MySuper product.

‘Formal competitive process’ are the operative words in the above statement of objectives. Two problems arise from framing the review in this manner. First, it narrowly presents the issue as a matter of the *mechanism* by which default members are allocated. It is argued below that *who chooses* is primary, given the nature of the default superannuation segment and default members. Focusing on the entity that is responsible for the selection of the default provider raises important questions such as alignment and

²Under the MySuper default regime, ‘provider’ and ‘product’ are (nearly) synonymous under the requirement that Registerable Superannuation Entities should offer one MySuper fund.

³ See http://www.cifr.edu.au/project/structure_and_Responsibilities_in_Default_Superannuation_Funds.aspx

⁴ See http://www.cifr.edu.au/project/MySuper_A_New_Landscape.aspx

⁵ Murray et. al. (2014).

⁶ The PC issues paper mentions competition 28 times, and choice 23 times. Best interests and trust and confidence are referred to in the criteria, but receive only two and one mention otherwise. Fiduciary duty is not referred to at all.

understanding of members, and whether effective competition between providers can be engendered over aspects that matter most to members. In addition, the framing presumes that the mechanism used to select providers should be determined as a matter of policy. This may not be necessary: indeed, it may be dangerous to do so. Another approach would be to focus on ensuring that the responsibility for selecting the default provider is in the right hands, and then allow those with this responsibility to specify the mechanism by which they choose providers or products.

Second, there appears to be an implicit assumption that a ‘formal competitive process’ will generate the most efficient outcome. This need not be the case, especially in the default superannuation segment where potential for market failure arises because defaulting members do not deliver clear signals. Further, members are heterogeneous and have different needs. These features make it important for those making decisions on behalf of default members to be aligned with those members, and as close to them as possible so that they can build a good appreciation of their needs and cater accordingly. The risk with a formal competitive process is that it places distance between the members and those responsible for selecting the provider, hence leading to outcomes that are less attuned to member needs. These matters are elaborated on below, after which a recommended solution is offered.

Heterogeneity Implies that Tailoring is Valuable

Substantial heterogeneity exists in the superannuation system. Members differ along many dimensions, including balances, contribution amounts and history, age, gender, assets outside superannuation, household status, and so on.⁷ Funds also differ in the member bases that they service. Recognition that such heterogeneity exists, and the importance of addressing it if possible, were a key finding of the CIFR research into MySuper design (see Butt et.al., 2014). This research found that most providers designed their MySuper products for a ‘typical’ default member. However, they did so after considering the specific nature of their member base, with definitions of a ‘typical’ member varying across funds. For instance, funds with younger members and low average balances often designed their MySuper product differently to funds with older members and high average balances. In addition, recognising that members are different, many funds are looking for ways to enhance their capability to tailor to members, notwithstanding being required to offer a single MySuper product. This desire to increase tailoring has manifested in the emergence of lifecycle products, as well as increasing investment in member profiling, member engagement and advice. A key conclusion of the CIFR MySuper research is that there is a need for smarter defaults to address member heterogeneity, especially given that many members accept the default they are offered as a matter of trust.

The potential for sub-optimal outcomes increases under ‘one-size-fits-all’ defaults in the presence of heterogeneity. The implication for the review of default arrangements is that care should be taken to engender the scope and incentive for tailoring, including fostering the development of smarter defaults. The problem with mandating a particular selection mechanism or criteria is that it could hamper tailoring. The risk increases under approaches that aim to cater for broad cohorts of members. Effective tailoring requires getting closer to members, rather than aggregating them into larger groups. Tailoring also requires an element of flexibility to design products that are appropriate for the circumstances. This occurs more readily under diffuse than centralised arrangements.

⁷ While member heterogeneity exists in accumulation, it is even more marked in the retirement phase. Ideally this heterogeneity in retirement should be linked to the design of default accumulation products through the adoption of a ‘whole-of-lifecycle’ view. For example, the need for de-risking as retirement approaches may depend on a member’s balance, their likely access to the pension, and the existence of assets outside superannuation. The policy framework should ideally facilitate tailoring by linking the design of accumulation products to heterogeneous retirement needs. One of the shortcomings of the MySuper regime is that it ends at retirement.

Who Chooses Should Be Primary

Most default members rely on others to make decisions on their behalf, and trust that the default they are being offered is suitable. While this is often attributed to disengagement, CIFR research by Butt et al. (2015) suggests that trust combined with lack of skill and confidence to make decisions are more important determinants of the willingness to accept the default.⁸ Either way, default members are largely incapable of driving effective competition between superannuation fund providers. They are also not very good at signalling their needs to those who make decisions on their behalf. Effectively, there exists a high degree of information asymmetry between default members and their product providers and others that they rely on, such as the employer who selects a fund provider. This information asymmetry increases the potential for market failure, and makes it more difficult for market-based solutions to be effective.

The concept that default members are relying on decisions made by others is critical. Any redesign of the default system should flow from this basic fact. The key implication is that the nature of those who choose the fund provider and/or the default product becomes a primary issue. It is this entity that makes the call on what will be delivered to default members, who in turn tend to accept what they are offered as a matter of trust. The effectiveness in performing this task depends on aspects such as motivation, skill, and understanding of members and their various needs. The nature of the entity that makes decisions on behalf of default members should be the overriding concern. Even under a formal competitive process, such as a tender or auction, somebody still has to set the criteria by which providers or products are selected and then make the choice.

Desirable Attributes, and A Way Forward

If an entity that selects the default fund provider is to deliver an efficient outcome in accordance with member needs, they might be expected to possess the following attributes:

- *Concerned with member interests* – They should act in the best interests of members, and not be subject to conflicts of interest.
- *Knowledge and skill* – They should have the technical capability to identify the providers or products that are most suitable for the member.
- *Well-positioned to identify member needs and design selection criteria* – They should be close enough to default members to understand their needs, set appropriate criteria for the selection of default providers in accordance with those needs, and have the flexibility to evolve those criteria over time.
- *Free to select from a range of providers*– Freedom to select from a range of providers will help ensure the best choice is made, and drive competition between providers.
- *Accountable* – The entity should be held accountable; and there should be a mechanism by which they can be replaced if they are not performing as required.

The current selection of default fund providers (as described in Figure 2 of the PC Issues paper) comprises a variable mix of arrangements, most of which fail to demonstrate at least some of the attributes listed above.⁹ The closest is situations where engaged, larger employers select providers using a competitive tender.¹⁰ Unfortunately, only a small portion of default members is covered by such arrangements. Accordingly, this submission recommends the establishment of a new class of *member agent* that is specifically charged with the role of selecting the default product provider. The underlying philosophy is that a more efficient outcome will arise if the responsibility to design criteria and then select the default

⁸ It is highly likely that this situation will not change, given that most fund members have low financial literacy, and are unlikely to ever attain sufficient knowledge to confidently make their own decisions.

⁹ We do not review the current arrangements, noting that the PC wants to work from a 'no defaults' baseline.

¹⁰ Corporate tenders are discussed in Appendix C of the PC's draft report of August 2016.

provider is assigned to a dedicated entity that demonstrates the attributes listed above. The aim is to create a class of entity that can select the default provider best able to satisfy potentially diverse member needs, while driving competition in the default segment from a grass roots level. These member agents should have the flexibility to establish their own selection process, and evolve it over time. While the selection mechanism may well entail a ‘competitive process’, such as what currently occurs under tenders for larger corporate superannuation funds, there should be scope to use other means where this better accords with member requirements. The overall policy objective would be to ensure that the right type of entity is making the selection on behalf of default members, rather than to mandate a particular type of competitive mechanism by which default providers or products are selected.

Relation to the Three Allocation Models

It is worth commenting on how the matters raised above relate to the three allocation models referred to in the PC’s Issues paper - administrative, market-based, and active choice by employees. Models involving active choice by employees should be immediately ruled out on the basis that default members are unwilling and often incapable of making effective choices and drive competition. There are also reasons to be highly sceptical of administrative solutions involving the selection of default providers by government representatives. An administrative solution is likely to be highly aggregated, making tailoring more difficult. It is debatable whether government representatives would be effective in performing the selection task, given that they are likely to be disconnected from the specific needs of members, and perhaps less likely to possess the required skill or market knowledge (although this is feasible). The track record of governments in overseeing and managing outcomes involving negotiation with market participants also leaves much to be desired. With respect to market-based models, the problems with a formal competitive process such as a tender or auction are discussed in the next section. The recommendation of this submission to establish member agents could be seen as a form of market-based model, but with a twist related to the imposition of a duty to operate in the best interests of members that alludes to fiduciary duty.

Scope for Inefficient Outcomes under Formal Competitive Processes

Formal competitive processes that allocate broad cohorts of members by an open competitive tender or auction, such as some variation of the Chilean solution referred to by the FSI, have three main problems:

- *Commoditisation is invited, when tailoring and smart defaults are needed* – A big risk with a competitive tender is that it would cut against the need for greater tailoring and smarter defaults. Whereas it is possible to include the ability to tailor on the list of selection criteria, the key inhibiting factor will be the level of aggregation. The broader the cohort of members to whom a tender applies, the greater will be the difficulty of understanding and catering for member diversity, and the more likely that commoditised solutions would be invited. For instance, tendering for the right to collect a share of all available default contributions is likely to attract products that are designed to meet the general needs of a wide spectrum of members at a low cost to the provider.
- *Cost may override net benefit* – What matters to members is net benefit, not cost in isolation. A tender approach could encourage costs becoming the central focus due to their saliency, and the fact that they have become the point of attention in the policy debate.¹¹ The introduction of MySuper provides a hint of what might happen. Many retail funds responded to the renewed focus on fees brought on with the introduction of MySuper by moving towards passive investment and reducing exposure to alternatives (see Chant et al., 2014). While the efficacy of these product changes might be debated,¹² it illustrates

¹¹ For instance, most of the analysis and discussion in the FSI was directed at cost, rather than net benefit. However, the PC should be congratulated for pursuing a broad view of cost versus benefit in the task of assessing the competitiveness and efficiency of the superannuation system, as apparent from in the draft report of August 2016.

¹² Whether retail members are better off as a consequence of these changes to product design is a moot point. The shedding of alternatives is probably a backward step, as it cuts out access to attractive return sources that also offer

how increasing the focus on costs over net benefit can drive the agenda, potentially leading to the shedding of higher cost activities without due consideration to their value to members. This point is also connected to the need to accommodate, if not encourage, tailoring and smart defaults.

- *Mandated solutions can be inefficient, inflexible, and have unintended consequences* – Governments are not prescient, and imposing a particular solution as a matter of public policy often leads to less efficient outcomes. Mandated solutions can become politicised or entrenched, which can hamper the flexibility to choose the optimal design in the circumstances and evolve it as times change. They can also have unintended consequences. For example, the reaction of providers to a winner-takes-all tender is hard to predict. Many providers will face the prospect of missing out on regular default inflows. This could impact on perceived security of funding, possibly leading to decreased investment horizons or increased reluctance to invest in higher-returning illiquid alternatives. Directing the attention of the industry to the tendering process might distract from other important functions, and could increase costs incurred within the system as a whole. The point is that the difficulty of predicting outcomes should lead to a preference for more flexible and diffuse arrangements involving establishing the right structure and environment, then allowing those at the coal face to decide.

In short, while imposing a formal competitive process involving a tender may be successful at minimising fees paid by members, it will not necessarily produce the most efficient outcome. The key reason is the potential to gravitate towards commoditised solutions that may not be in the best interests of members, who would benefit from more tailoring and smarter defaults. The broader the scope of any tender, the greater would be the risk. Other potential problems are deflection of attention away from net benefit, loss of flexibility, and unintended consequences from mandating a particular solution.

Suggested Alternative – Member Agents

Consideration should be given to establishing member agents with specific responsibility for the selection and monitoring of default providers. These entities would be allocated this responsibility either by employers, or be assigned by an administrator such as the Fair Work Commission.¹³ Effectively those that are currently charged with selecting the default provider would be required to pass this function on to a specialist. It is envisaged that member agents would be private sector businesses, with a number operating in the market to service groups of employees/members across a range of workplaces. Member agents would be remunerated by a small charge on default member balances, to be collected by default providers as a component of member fees and remitted.¹⁴

Member agents could meet the desirable attributes as listed earlier in the following ways:

- *Concern with member interests* – Member agents would be deemed to either owe a fiduciary duty to members, or be placed under a legal obligation to act in the best interests of members. Conflicts of interest could be managed by requiring independence as a licensing condition.
- *Knowledge and skill* – Member agents would have access to expertise through being managed and staffed by industry experts, probably supported by drawing on the resources of superannuation industry research houses. Indeed, this approach may represent an opportunity for the industry research houses and tender consultants to broaden their role.

diversification. Whether the move to passive investment provides a net benefit depends on the efficacy of active investment, which has been successful in some assets (e.g. Australian equities, especially small-caps) but not others.

¹³ This is a variation on the idea of the Fair Work Commission selecting the default provider, or a shortlist of default providers, except that they would be appointing experts to make the selection.

¹⁴ For instance, a 1 basis point charge would amount to \$63 million in available fees based on the \$629 billion of assets in MySuper products listed in the APRA data at June 2016.

- *Well-positioned to identify member needs and design selection criteria* – Member agents would be required to select providers based on criteria that are designed around the needs of particular member groupings. It is envisaged the criteria would take into account the entire suite of services offered to default members, including potentially costly but value-adding activities such as capability to invest in alternative asset classes, availability of smart defaults, advice offerings, and so on. The suite of services would be weighed against fees in order to establish net benefit. Member agents would also be responsible for: establishing objectives for the provider; specifying the agreed services to be delivered; determining the manner in which the provider is to be evaluated; and setting the term of contracts. To perform their task effectively, member agents would be required to build an understanding of member needs. This would probably involve conducting member research to understand the nature of groups of members operating under a particular employer or within a specific industry.
- *Free to select from a range of providers* – The aim would be to select the most suitable provider from the range of those available, which should extend to any registered MySuper product. It is envisaged that tender processes might be conducted similar to those currently observed for major corporate funds. By selecting from the full range of available products, member agents would play a central role in driving competition among default fund providers.
- *Accountable* – Accountability will need to arise from other than the default members, who are unable to perform an effective monitoring role. Two points of accountability are suggested. The first is to the employer or administrator that appoints the member agent. These parties should have the responsibility to monitor the performance of the appointed entity, and the capability to replace them if they fail to perform in accordance with basic requirements. Second, member agents would be registered and monitored by APRA as part of its prudential oversight of the superannuation system.

This arrangement transfers the responsibility for selecting and monitoring the providers of default superannuation products into the hands of a specialist that is solely concerned with the best interests of members. The approach should foster competition between providers within the default segment from the grass roots, which is preferable over models that involve centralising the process. The skilled nature of member agents, coupled with their understanding of member needs, should help overcome the problem of severe information asymmetry in the default segment involving largely uninformed members, hence reducing the potential for market failure. Member agents will engender competition around the delivery of net benefit to members, balancing cost against the value of services such as capability to invest in alternative asset classes, ability to offer smart defaults, or access to advice. While no system is perfect, this approach should give the best chance of delivering an efficient outcome in accordance with member needs.

Of course, the member agent approach gives rise to some issues. Competition between member agents may be difficult to foster; and they may become entrenched once assigned to a group of members. However, this problem pervades many areas of the superannuation system at present, mostly with respect to fund providers, e.g. nomination under an industrial award. Introducing an entity that is responsible for selecting fund providers simply moves the potential entrenchment problem up a level to where members are arguably less exposed. Member agents would also have considerable power to direct the movement of billions of dollars of assets, which creates its own issues. This gives rise to the potential for funds to be concentrated towards a few favoured providers, possibly giving rise to systemic. A decision to withdraw funds from a provider might also undermine their business. These possibilities reinforce the need for oversight by APRA to guard system integrity. The existence of an entity that has the power and flexibility to switch providers may work against the adoption of longer investment horizons or investment in illiquid alternatives by lowering security of funding, which could be to the detriment of long-term returns. However, most of these issues also apply to many of the alternative structures that could be contemplated, including centralised tender or auction approaches.

Concluding Comments

This submission raises a few key points. The central message is that the PC and policy makers should direct their attention towards the *entity* that holds the responsibility for selecting and monitoring the default fund provider, rather than the *mechanism* by which providers or products are chosen. An arrangement is suggested that involves establishing a new type of private entity – *member agents* – who are explicitly charged with the role of selecting and monitoring default providers on behalf of members. Member agents would possess industry expertise and understanding of member needs, and be charged with a duty to act in the best interests of members. They would become central to driving competition between default providers. They would have the flexibility to run their own selection process, rather than having it mandated as a matter of policy. This submission also warns of the dangers of pursuing market-based mechanisms that involve tenders or auctions for the right to manage super for broad cohorts of default members. Such an approach is likely to lead to commoditisation when greater tailoring is required, as well as perhaps too much focus on cost rather than net benefit to members.

Authorship:

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