Living In An Empirical World

The Best Retirement Income Systems in the World Rely on Industrial Defaults

Alternatives Developed by the Inquiry Should Reflect the Evidence: Netherlands, Denmark and Australian Industry Funds Perform Best

28 October 2016

Industry Super Australia

ABOUT INDUSTRY SUPER AUSTRALIA

Industry Super Australia manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of over five million industry super members.

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LIVING IN AN EMPIRICAL WORLD

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Introduction

Industry Super Australia's mission is to maximise the retirement benefits of industry super fund members. Industry super funds have a proven record of effectively and efficiently managing the savings of millions of Australians. For as long as the data have been collected, industry super funds have outperformed by delivering above average long-term net returns to members.

Australia's default superannuation system is important to the wellbeing of a large part of our population, our financial markets, and the economy. Millions of Australians rely on default superannuation settings. Hundreds of billions of superannuation assets are managed pursuant to these settings.

Fortunately, the default super system in Australia has generated very good results, materially outperforming all other segments for as long as the data have been recorded.

By contrast, the parts of the superannuation industry sold by banks, financial planners, and other for-profit providers, have substantially underperformed, resulting in the beneficiaries of that sector being poorer – and harming the Commonwealth fiscal position and economy as a whole.

This disparity – between (1) a high performing, not-for-profit default system built on a culture of serving others, and (2) a for-profit, sales-based system built on the self-serving financial services culture – might have led well-intentioned policy makers to ask the Productivity Commission to develop an alternative superannuation system architecture that combats the inefficient and rent-seeking behaviour of banks and wealth management firms. But, instead, the Commission has been asked to develop alternatives to the best performing and most efficient part of the system, and one of the few parts of financial services that is not held in low regard by the public.

In Australia, and around the world, there are different ways of implementing retirement security policy, including different approaches to default settings in funded retirement income systems. Some have worked well, some have not. The Inquiry should build on those parts of the Australian system that have worked well, and look to those countries whose superannuation systems are world class.

The best funded retirement income systems in the world – just like the best performing funds in Australia – are based around employers and unions working together as "social partners" to deliver efficiency and retirement security for beneficiaries – not making a profit for shareholders.

We appreciate the opportunity to comment on the Issues Paper regarding this Inquiry. The Issues Paper provided useful insights into how the Commission categorises default selection processes and provisionally plans to undertake the Inquiry. Our comments are focused on those areas of the Issues Paper where we have different or additional views.

Key points

- There is an existing default system in superannuation. It looks after over $400 billion of savings on behalf of about 7 million people, and has materially outperformed the system average for as long as data have been recorded. This is important to the Commission's Inquiry because displacing a longstanding and effective system covering millions of people should not be done without an iron-clad justification. This Inquiry (not a later one) is expected to produce "viable alternatives for the Government's consideration."[1] Sensible policy makers will struggle to consider an alternative to be "viable" unless the benefits of that alternative – relative to the existing default system we have today – clearly and concretely justify the costs and risks of change to a well-performing model recently ranked 3rd in the world.[2]
- In considering alternative approaches to default superannuation, the Inquiry should draw on the best systems in the world. Denmark and the Netherlands have consistently had the most highly regarded and best performing pension systems in the world, largely due to the quality of their funded retirement income systems, i.e., their 2nd pillar architectures. The 2nd pillar architecture in Denmark and the Netherlands is based on the "industrial model," which has the following core features:
  - The 2nd pillar default providers are private, industry or multi-industry plans that generally are affiliated with industrial parties and operated on a not-for-profit basis;
  - Products are distributed through the workplace; and
  - The default product is determined through either industry or company level collective agreements between unions and employers.

  The best performing part of Australia's 2nd pillar is the existing default system, which also follows the industrial model, and shares these characteristics.
- The reason Denmark and the Netherlands are the best performing system in the world, and the Australian industry funds are the best in this country, is because of culture and values. Asset allocation, efficiency in administration, manager selection, and the other operational efficiencies did not happen by accident. They emerged because of culture. Industrial parties are central to efficient and effective 2nd Pillars because they engage in superannuation to *serve others*. It is the industrial parties who designed and built these very efficient systems, not to make money for themselves, but to deliver the best outcomes for members.
- Though no fault of the Commission's, the basis for the present Inquiry is in error. The Issues Paper is part of a response to the view of the Murray Inquiry that the superannuation system is inefficient. The Murray Inquiry was right about that – superannuation overall is inefficient. However, the default system is *not* the reason. Quite the opposite. Default funds substantially outperform self-managed funds and choice funds. The inefficiency in superannuation arises from those parts of the system *other than the default system*. This is important to the Commission's Inquiry because it counsels in favour of a default system that has greater coverage, and has much stronger protections for those who might leave its safeguards. Specifically, for members who are not covered by a modern award or enterprise bargaining agreement, only MySuper applies, which is not adequate. In addition, if greater efficiency is the focus, the Inquiry's intent to apply the alternative allocative model only to those "who do not make an active choice about their superannuation fund" will continue to enable movement from the best performing segment into underperforming ones.

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[1] Productivity Commission, Issues Paper, Superannuation: Alternative Default Models, September 2016, p iv

[2] See, Melbourne-Mercer Global Pensions Index 2016.

- The manner in which defaults are selected should be rigorous, and focused primarily on maximising the financial outcomes for beneficiaries. Defaults should be selected based on merit. The Fair Work Act was recently amended to codify the factors the Fair Work Commission should consider in evaluating default applications. The matters identified are well-considered, including (i) the appropriateness of the long-term investment return target and risk profile, (ii) the expected ability to deliver on the long-term investment return target, (iii) the appropriateness of the fees and costs, (iv) net returns, (v) whether the superannuation fund's governance practices are consistent with meeting the best interests of members of the fund, including whether there are mechanisms in place to deal with conflict of interest, (vi) the appropriateness of insurance, (vii) the quality of advice, (vii) the administrative efficiency of the fund, and any other matters the Fair Work Commission considers relevant. This process builds on a demonstrated track record, and is consistent with models in other countries that are considered world-leading.
- The Issues Paper proposes an approach to this inquiry that is very abstract, and runs the risk of producing a report that is at best of little practical utility, and at worst could be misleading. The Issues Paper proposes to use an alternate reality – where there are no defaults – as the "preferred baseline" for assessing different "models." This baseline does not exist, and there are no data about it. Creating abstract models and assessing them in imaginary conditions is perhaps not the best approach "to develop a workable model… that could be implemented."[3] It could expose the Australian people to proposals that once appeared attractive to some economists based on theory, but have actually delivered poor results in practice compared to Australia's current system – such as those implemented in Chile and New Zealand.
- In line with the terms of reference, this Issues Paper gave some prominence to the allocation systems in Chile, as well as New Zealand and Sweden.[4] The Inquiry is not required to recommend an approach based on the systems in these countries. Other than Sweden, none of these systems are generally viewed as among the better systems in the world.[5] The outcomes for beneficiaries are mixed at best. Instead of countries like Chile and New Zealand, the Inquiry should seek to inform its work by referring to the systems in Denmark and the Netherlands, which are widely regarded as the best funded retirement income systems in the world. The fact that the Pillar 2 products in these countries provide a different form of benefit[6] is not a reason to exclude them from this Inquiry because the focus of this

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[3] Id.

[4] The Terms of Reference indicate that the Inquiry "should consider the merits of different approaches…. This should include consideration of … the strengths and weaknesses of competitive processes used internationally, such as Chile, New Zealand and Sweden." This does not require the Inquiry to limits its consideration to these countries, or to view them with favour.

[5] For example, only Sweden is in the top quartile of the 27 countries in Melbourne-Mercer global pensions index. Sweden has a good system, but not because of the allocation program for the "premium pension" that was referenced in the Issues Paper, which plays only a small role in the outcomes for Swedish beneficiaries

[6] The Issues Paper suggested the Inquiry would focus on defined contribution systems. Such a limitation is unnecessary as there are very few countries that are dominated by true defined benefit systems. 2nd Pillar institutions in both Denmark and the Netherlands are entirely or predominantly collective DC (largely conditional indexation plans).

See, OECD Pension Markets in Focus (2014) at 15 (stating that "In Denmark, DB plans constitute a small part (6.6%) of the Danish pension fund market.")

See, Ponds and van Riel (2007), Sharing risk: the Netherlands' new approach to pensions, Center for Retirement Research at Boston College, Brief Number 2007-05 (stating that, although "Official statistics classify … funds as DB schemes…, a typical characteristic of these schemes is that indexation of all accrued liabilities is dependent on the solvency position of the pension fund through a so-called 'policy ladder.'" In other words, they are conditional indexation plans.)

Inquiry is on how superannuation can be distributed, not its benefit design.[7] It is also reasonable to expect that, as our superannuation system focuses more on efficiently delivering retirement income, the differences in benefit design will necessarily reduce.

- The Issues Paper assumes that default products will be accumulation only. Ideally, the Inquiry should look to the future. The superannuation system is expected to transition from a system focused on accumulation, to a system that delivers retirement income, initially recommended by the Cooper Review. Industry is seeking to innovate in this area. A practical and evidence-based set of recommendations from the Commission that outline a default allocation model for whole-of-life retirement income products could assist in this transition.
- The Issues Paper ignored culture and values. The best performing superannuation funds are those who have a culture of *serving others*, and are guided by the best interests of members, not shareholders or other related parties. Culture is an essential part of a high performing fund, because the opportunity to act disloyally to members is high. Providers have greater information and capacity to interpret it, high levels of discretion, and the outcomes of their behaviour manifest only after a long period of time, which makes shorter term indicators and incentives ineffective. No market model selection process will eliminate these conditions. Some processes could even encourage undesirable behaviours. Default super is an instrument of public policy, therefore providers should be oriented solely toward delivering good outcomes for the public.
- Competition is no substitute for culture. Competition prioritises *serving yourself,* seeking to elevate self-interest and harness it by making rewards conditional on winning a contest. As the Commission has elsewhere observed,[8] competition is just a potential tool or mechanism to achieve other ends – sometimes it is an appropriate and effective tool, sometimes it is not. The data suggest that, at least in superannuation, competition has not been effective. Even technocratic processes, just like consumer-based competition, can never fully overcome information asymmetry, and can always be gamed. These processes also are no substitute for culture. Technocratic processes have been tried in other countries and universally underperform the industrial model.
- The proposed criteria for assessing models should include resilience against finance sector regulatory capture; practicality; protections against loss-leading behaviour; and ensure that the voice of employees, as well as employers, is heard.
- The Issues Paper did not explain how the Inquiry would estimate the outcomes of different models in the abstract and relative to the proposed baseline. For example, it is unclear how the Inquiry would project the changes to expected net returns to members if the default allocation system was changed.

Moreover, this Inquiry is about how members are allocated to default products, not about benefit design. There is no reason why Australian policy makers cannot be informed by a defined benefit system that has a very efficient and effective allocation mechanism.

[7] It might also be the case that the Commission could learn from the benefit designs in these countries, which have sought to achieve sustainability while also maintaining the substantial efficiency gains of collective risk management.

[8] See, Productivity Commission 2016, *How to Assess the Competitiveness and Efficiency of the Superannuation System*, Draft Report, Canberra, at 4 (stating that "Competition in the superannuation system is not an end in itself, but an intermediate objective insofar as it drives more efficient outcomes for members.")

Discussion

1.1 The importance of default settings

Superannuation is an instrument of social policy. It is a core part of the Australian retirement income system. It combines with the Age Pension and other savings to improve living standards for the aged.

Superannuation involves compulsory savings, because otherwise citizens would undersave.

But simply mandating savings is not enough. Public policy needs to connect savings to high quality providers and products. Not only do citizens undersave, but they also seldom choose a product – and are not well-equipped to make choices in most circumstances. Choice is negatively associated with financial outcomes.[9] Default settings are necessary to ensure that retirement savings are managed effectively to achieve the social policy objective efficiently.

Currently, about 80 per cent of superannuation members join a fund through the workplace. A small percentage of members switch funds in any given year, and often the switch is due to a change in employer. In the absence of default settings, there is a lack of clarity about where these savings would be placed, and no guarantee that the savings would be managed by a high quality provider in the best interests of the member.

The empirical evidence is clear that few people choose a product, and few are well equipped to do so. In fact, much of the "choice" that does occur is actually driven by sales efforts – most financial services are "sold, not bought". The introduction of choice into the Australian policy architecture was effectively a decision to expose individuals to the selling efforts of providers, notwithstanding that most people are not well suited to evaluate these efforts.

The Inquiry's preferred "no defaults" baseline lacks coherence

The rationale for the Inquiry's preferred baseline for assessing alternative models is unpersuasive and risks an over-reliance on subjective interpretation.

The Inquiry claims that a "no defaults" baseline would enable objective comparisons. However, the baseline would not facilitate meaningful comparisons because the baseline cannot be rigorously specified or quantified; the baseline, if it can be constructed, will be predominantly conjecture. The Inquiry does not specify where contributions would go if members do not choose a product. It does not specify how many funds or products would exist. It does not specify what products would be available and under what terms and conditions. It does not specify what information would be available to members, or how much it would cost to obtain and process that information. It does not specify how employers and unions would respond. It does not specify how providers would respond. It does not specify how members would respond.

The Inquiry's proposed baseline lacks analytical rigour because it cannot be empirically verified. Coming to some view on the above matters – and countless other vitally important beliefs about the baseline – will require a rationale in each instance: the Inquiry will need to explain, with rigour, why it believes the "no

[9] See, Gan, Su et al., Individual investor portfolio performance in retirement savings accounts, Australian Journal of Management, 2014 (analysing 10 years of data for over 15,000 members and finding that "Switching activity is invariably associated with lower risk adjusted returns (alphas) and this is also evident across the various analyses reported.")

Switching between funds is also associated with negative performance: on average, self-managed super funds underperform APRA-regulated funds according to ATO statistics. Default funds named in modern awards outperform both APRA-regulated funds and self-managed funds on average.

defaults" baseline would have the characteristics it specifies. Evidence will be required. Among the many challenges with doing so will be introducing this baseline into history. In the Inquiry's imaginary baseline, are defaults abolished tomorrow? Or did the superannuation system start with no defaults? Or something in between? The choice of when the hypothetical is introduced in time will powerfully affect the character of the hypothetical baseline.

An objective baseline is desirable, but the proposed approach would not achieve that. The only objective baseline is Australia's existing default system. An objective, as opposed to subjective, comparison requires all alternatives to be evaluated pursuant to the same standards applied reasonably, i.e., without regard to individual biases and interpretive perspectives. Using a hypothetical baseline will introduce significant risk of bias and subjective beliefs because specifying the baseline will involve subjective beliefs about what "would have happened" if there were no default. Using the existing default superannuation system as the baseline is the only way to enable objective comparison because there is significantly less opportunity for beliefs and prejudices to colour the construction of the baseline: Australia has an existing default system, and the facts about it are objective.

The Inquiry should carefully consider how much weight policy makers could reasonably give to the Inquiry's assessment of alternative models (which will themselves be hypothetical) against a hypothetical baseline.

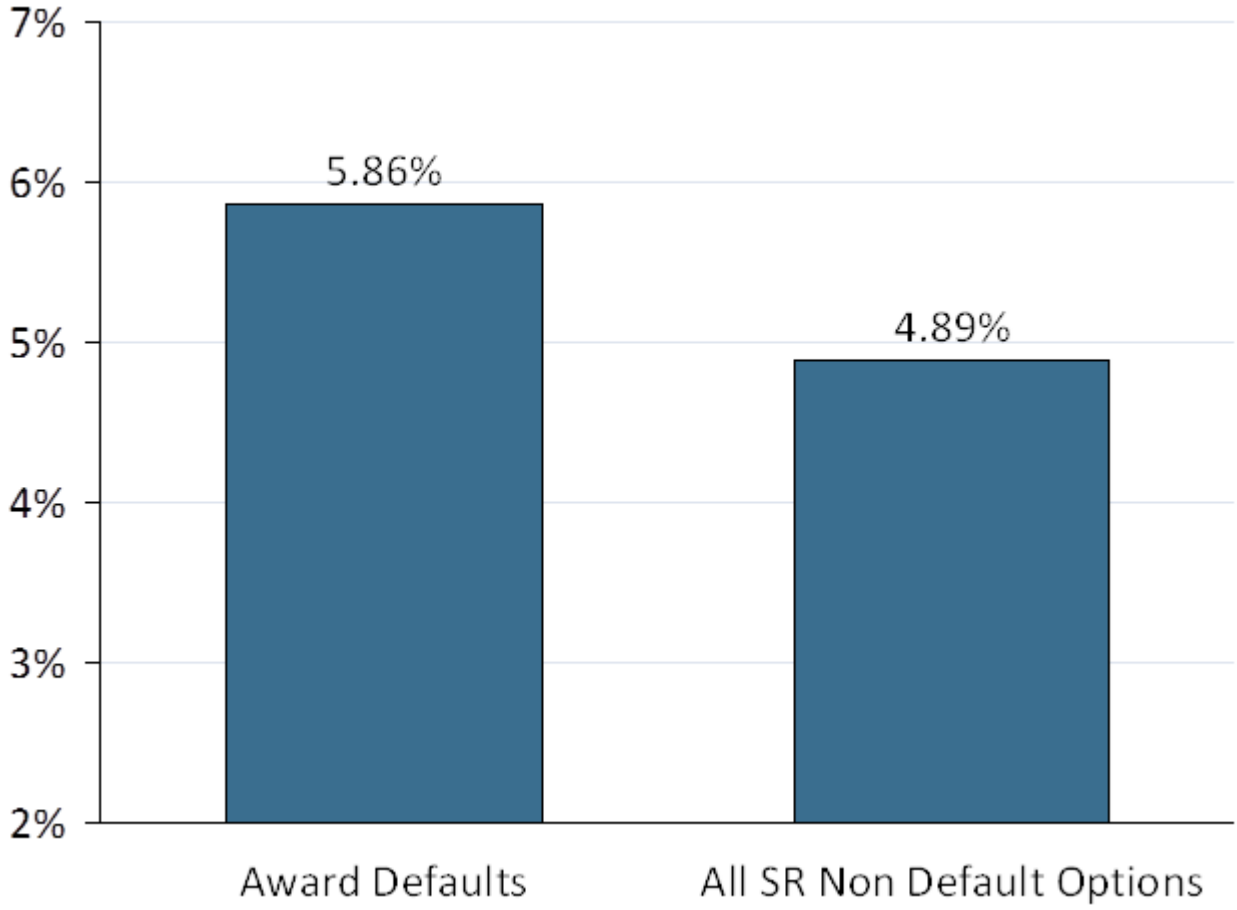
Proceeding to undertake the inquiry with a baseline of "no defaults" seems a grave and unnecessary risk to the credibility of the process.

Existing default settings have been effective

The default fund in most workplaces is determined by the employer (which, for state and federal government employees, is the relevant government or agency). The employer selects the workplace fund, usually in consultation with employees or their representatives, from a list of eligible default funds named in the relevant Modern Award or specified in an enterprise bargaining agreement (EBA).

Funds named in Modern Awards as eligible defaults have outperformed other parts of the system, as shown in Figure 1.

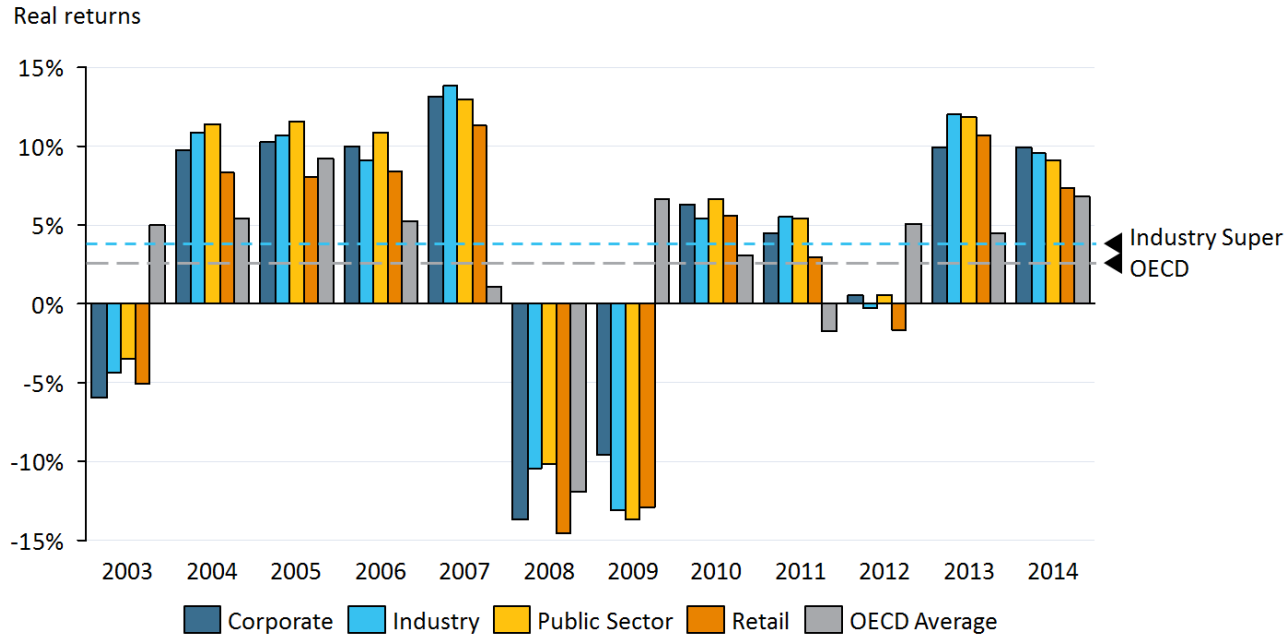
Figure 1 – Performance of defaults named in awards compared to other options



Source: SuperRatings Smart Database, ISA analysis of SuperRatings option-level data for 46 funds listed in awards for which data are available
Note: Performance is the average for the 10 years to September 2016 (weighted averages).

Not only do Australian default funds outperform the system-wide average, but they also outperform the OECD average, as shown in Figure 2.

Figure 2 – Industry super funds outperform the OECD average



Source: SuperRatings, OECD, ISA analysis

The inefficiency in the superannuation system that was of concern to the Murray Inquiry, and motivated this Inquiry, arises from the movement of members and assets from the high-performing default system, into the choice and self-managed super fund (SMSF) sectors. The part of the existing system that needs improvement is that there is too much movement from high performing default funds into lower quality products. This movement is substantially driven by the selling efforts of for-profit providers.

Where industry super funds and other not-for-profit funds act as default super funds, the member and economic outcomes are superior to those delivered by other superannuation models. These funds have provided a well-functioning "safety net" for Australian workers compelled to save for their retirement who typically do not choose their own superannuation fund. The outcomes delivered by not-for-profit funds is due to their "members first" culture, and the fact they have invested a higher proportion of their members' savings in illiquid assets (such as nation building infrastructure, property and private equity) which deliver superior long-term returns, and lead to greater capital formation.

Uplifting the efficiency of the superannuation system as whole requires expanding the coverage of the safety net as much as possible. In addition to strong default settings, the Inquiry should give regard to designing mechanisms to prevent movement from the safety net that reduces the efficiency of the system and/or outcomes to members.

1.2 Australia should aim higher than the Chilean system

In determining what jurisdictions the Inquiry will draw from in evaluating alternative member allocation systems, the Inquiry should first identify the best performing systems in practice, and then seek to identify what elements of those systems are responsible for the superior outcomes.

The empirical outcomes of the Chilean model should counsel the Commission to steer clear. As shown in Table 1, OECD performance statistics indicate the system underperforms Australia, as well as the leading systems of Denmark and Netherlands. In fact, the existing Australian default system substantially outperforms the Chilean system.

Over the five-year and longer term 10-year real returns, the Dutch and Danish systems perform best. They also have the highest replacement rates. If there is an interest in evidence-based reform of the existing

Australian default system, these are the countries to which the Inquiry should look. By contrast, the 10 year real returns for New Zealand and Chile are in the bottom half of reported OECD data, and both countries have lower replacement rates than Australia.

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

Country	5 year average to 2014, % pa [1]		10 year-average to 2014, % pa[1]		Net Replacement Rate[2]	Net replacement rate, Pillar 2[3]	Adequacy Ranking[4]	Adequacy Ranking (Pillars 2/3)[4]
	Nominal	Real	Nominal	Real				
Netherlands	9.8	7.8	6.6	4.8	95.7	58.9	1	2
Denmark	8.9	7.1	7.3	5.4	66.4	50.7	2	3
Australia	8.4	6.0	5.6	3.7	55.7	35.4	35	4
Australia: Industry funds only[5]	9.0	6.4	6.6	4.8	-	-	-	-
New Zealand	8.6	6.3	5.9	3.3	43.0	14.6[6]	10	24
Chile	7.1	3.7	7.1	3.5	35.4	41.7	40	8
Sweden	*No data*				56.0	22.7	8	7

Source: OECD, Allianz, APRA, ISA calculations

Note: (1) OECD (2014), except for Australia: Industry Funds Only, which is based on APRA data (nominal) and ISA calculations (real); (2) Replacement rate is for the year 2014, (3) Replacement rate is for a median income earner for the year 2011, which is the most recent information available, OECD (2011); (4) Allianz (2015); (5) New Zealand's replacement rate is for its "Voluntary DC" Pillar rather than "Mandatory Private" Pillar because the OECD data places KiwiSaver under the former category.

Some commentators have championed the Chilean system by claiming it has led to reduced fees.

However, the initial reduction in Chilean fees after the 2008 reforms has not been sustained.[10]

More importantly, the Commission is already well aware that reducing fees is quite different from increasing net returns. The Commission is well-placed to resist the focus of some commentators on fees rather than net benefits.

In Chile, not only were fee reductions short lived, but a more careful look reveals significant value extraction by the competitively-selected default funds.

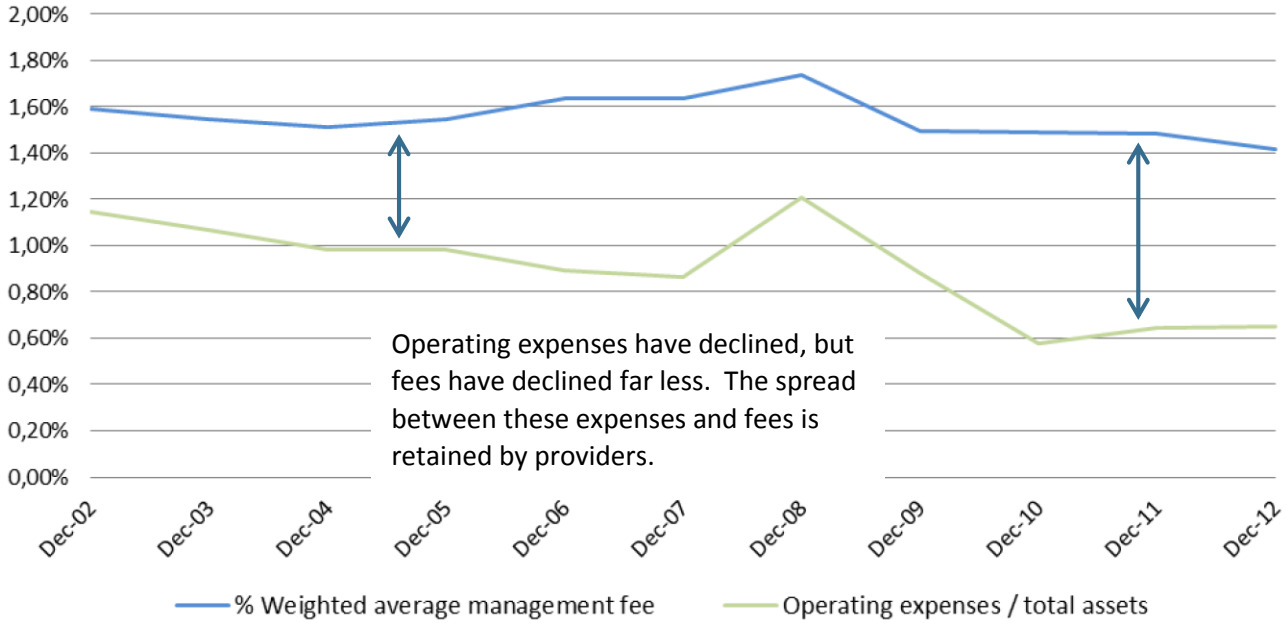
As shown in Figure 3, the reduction in fees achieved in the first years after the start of the system in 2008 did not continue. More importantly, profit margins for providers have grown steadily since the introduction of the system. These growing margins show that, while operating costs and scale efficiencies have of course emerged over time, *these efficiencies have not inured fully to beneficiaries* and have instead been retained by providers.[11]

Moreover, the margins retained by providers are *larger* after the introduction of the reforms.

[10] See, Professor David Blake, Financial Times, 12 September 2016 (stating that "Initially the Chilean model appeared to be very successful, but the sting in the tail appears to be that charges extracted by the industry have resulted in pensions being much lower than otherwise would be the case.") https://www.ft.com/content/b9293586-7680-11e6-bf48-b372cdb1043a)

[11] See, International Organisation of Pension Supervisors (2014) (stating that "a growing gap between fees and expenses can be observed, which effectively translates into a higher profit margin for the AFPs.")

Figure 3 – Average proportional charges on flows and operating expenses



Source: International Organisation of Pension Supervisors (2014) Update of IOPS Work on Fees and Charges; Superintendence of Pensions, Chile; ISA commentary

This outcome reinforces why the Inquiry should give regard to culture and values. Chilean pension funds are motivated by self-interest. Competitive selection processes, even if very simple and focused on fees, cannot discipline providers.

This outcome is different from how economic theorists claimed the Chilean system would perform and underscores why the Inquiry should be very cautious when projecting the benefits and costs of alternative schemes based on economic theory.

The disconnect between the outcomes delivered by the Chilean system, on the one hand, and public expectations, on the other hand, has given rise to mass protests.[12] While avoiding mass protests is not an explicit criterion of the Inquiry, it is a highly desirable feature of a default system.

1.3 Australia should aim higher than KiwiSaver

Credibly recommending changes to Australia's default system will require a very strong evidence base because the system has worked well. KiwiSaver cannot provide such an evidence base because – as observed by the New Zealand Treasury – it is still "in its infancy."[13]

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[12] See, "The perils of not saving," *The Economist*, 27 August 2016 at:

http://www.economist.com/news/americas/21705850-pioneering-system-now-need-reform-perils-not-saving

See also, Andrés Velasco, Australian Financial Review, 8 September 2016 (expressing the view that "A government-appointed commission recently concluded that managers have generated high gross real returns on investments: from 1981 to 2013, the annual average was 8.6 per cent; but high fees cut net returns to savers to around 3 per cent per year over that period. Those high fees have also meant hefty profits for fund managers. And it is precisely the disparity between scrawny pension checks and managers' fat profits that fuels protest. So, more challenging than any technical problem with Chile's pension system is its legitimacy deficit.") at:

http://www.afr.com/personal-finance/superannuation-and-smsfs/chiles-australianstyle-superannuation-system-feels-the-crunch-20160908-grbqdl

[13] New Zealand Treasury, Review of the KiwiSaver Fund Manager Market Dynamics and Allocation of Assets, September 2015.

Nonetheless, the evidence that we do have about the KiwiSaver system also counsels against using it as a reference for the Inquiry.

- KiwiSaver default funds have *underperformed* the KiwiSaver system average. The five original KiwiSaver default funds[14] have delivered a weighted average return of 5.9 per cent per annum over the past five years compared with 7.9 per cent for all KiwiSaver funds.[15]
- KiwiSaver default funds not only have lower performance than the average KiwiSaver fund, but are substantially lower than existing Australian default funds, as shown in Table 2. Over the seven year period to 2016, Australian default options in default funds named in awards generated average annual returns of 8.1 per cent (nominal) and 5.8 per cent (real), significantly more than the average KiwiSaver default fund.
- All KiwiSaver default funds are *for-profit* funds, with conflicts of interest.
- The KiwiSaver default system has very low coverage, suggesting low confidence or a leaky architecture. As of 2014, around 22 per cent of all KiwiSaver members were in default funds.[16] Given the well-known cognitive and behavioural challenges affecting individual management of retirement savings, a well-designed default system should aim for high, if not near universal, coverage.
- The manner in which the KiwiSaver default selection has been conducted suggests to some commentators that it was intended to reduce the government's exposure to risk, not to prioritise member's best interests. This view is based on the nature of the providers selected (large "name brand" providers), and the conservative investment allocations of the funds. (The risk that a government selection process could prioritise the government's interest rather than the interest of beneficiaries is discussed in more detail in Section 1.9, below.)

[14] Brian Gaynor, KiwiSaver fund choices leave money on the table, New Zealand Herald, 6 February 2016

(stating that "The five original default funds, which now have total funds under management of $6.6 billion, have delivered a weighted return of only 5.9 per cent per annum over the past five years compared with 7.9 per cent for all KiwiSaver funds and 13 per cent for the NZ Super Fund.")

http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11585335

[15] See, id.

[16] http://www.mbie.govt.nz/info-services/business/business-law/past-work-older-topics/changes-to-kiwisaver/default-provider-arrangements/documents-image-library/q-and-a.pdf

Table 2 – KiwiSaver default funds, average annual net returns, 2008-2016, % p.a.

Default Fund	Nominal returns	Real returns
ANZ	6.4	5.1
Mercer	6.2	4.9
ASB	6.2	4.9
Fisher Funds	5.9	4.6
AMP	5.4	4.1
BNZ	6.0	4.7
Westpac	5.2	3.9
Kiwi Wealth	5.2	3.9
Grosvenor Default Saver	6.0	4.7
Average KiwiSaver default	5.8	4.5
Average Australian default(1)	8.1	5.8

Source: interest.co.nz, APRA, ISA calculations
Note: (1) For the seven years to 2016 (weighted averages)

The KiwiSaver default system also is a lesson for policy makers that believe active choice is always and everywhere desirable, and should be universally encouraged.

KiwiSaver was designed not as a true, enduring, default system, but as a temporary holding system. It was hoped that an active choice would be made. According to the New Zealand Treasury:

> The original policy intent was that the default funds would be shorter term holding accounts in response to the inertia automatically enrolled members experience, until an active choice is made about a fund suited to their needs.[17]

Such an approach is problematic. Financial literacy (even if widely achieved) and full and fair disclosure (even if achieved) are not sufficient in themselves to protect consumers.[18] These measures cannot fully bridge the information asymmetry gap, and more importantly cannot overcome hardwired cognitive limitations. The literature is clear that even sophisticated investors can make basic mistakes, particularly when managing their own account.

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[17] New Zealand Treasury, supra note 14.

[18] It is important to note that existing disclosure requirements do not achieve full, fair, and comparable information.

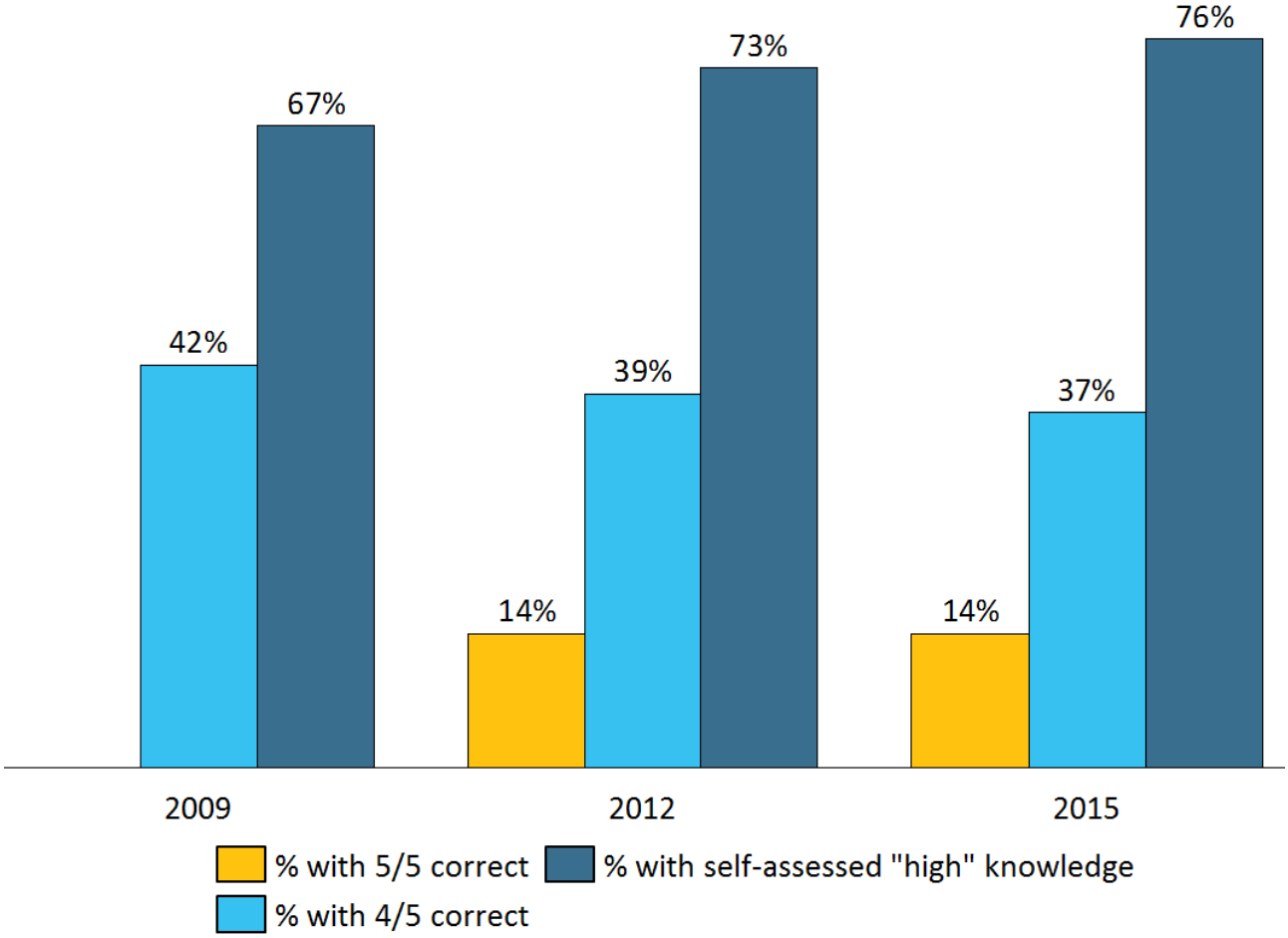
First, "compar[ing] the fees and costs of platforms with non-platform superannuation funds … is likely to be misleading." See, ASIC, Questions and answers - fees and costs disclosure - superannuation and managed investment products, available at:

http://www.asic.gov.au/regulatory-resources/superannuation-funds/superannuation-guidance-and-relief/fees-and-costs-disclosure/questions-and-answers-fees-and-costs-disclosure-superannuation-and-managed-investment-products/

Second, although MySuper does require standardised disclosures, existing disclosure requirements are not necessarily comparable or useful, particularly in relation to fees and costs including indirect costs.

Consider the United States: in spite of dedicating substantial resources to financial literacy efforts, the results have been very disappointing. Figure 4 shows the most recent results of a flagship study of financial literacy in the United States. It shows the percentage of people who were able to correctly respond to five simple questions relevant to assessing financial literacy.[19] As indicated by Figure 4, individuals are becoming more confident in their financial capability, but are actually becoming less able to answer basic questions correctly. There do not appear to be similar semi-longitudinal studies in Australia, however Australian studies that compare self-assessed financial literacy against actual capability show similar results to the United States.[20]

Figure 4 – As self-assessed capability increased, actual financial capability decreased



Source: Financial Capability in the United States (2016)

Moreover, the notion that consumers could reasonably be expected to make an "active choice" in respect of investment products defies decades of experience. Financial products generally are "sold, not bought." As a result, the New Zealand policy of pushing individuals to make an active choice simply exposed the public to the selling efforts of conflicted product providers. The Australian experience with Choice of Fund has been similar. These are policies that ostensibly are about consumer choice, but in practice are about allowing for-profit providers to sell products to consumers that would otherwise not pass muster.

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[19] Although most financial literacy studies only inquire about the self-reported literacy of participants, the better ones (i) inquire about both self-reported capability, and (ii) actually test participants to determine whether their self-reported capability is similar to their actual capability.

[20] See, Bateman et al., 2011, Financial competence and expectations formation: evidence from Australia (finding that "Respondents who rate themselves as having an average understanding actually score worse than average on the literacy quizzes, exhibiting the overconfidence in self-assessment that is common in survey responses.")

New Zealand should have designed a system in which members could be confident that their savings would be well-invested, whether they made an active choice or not.

The experience with the Swedish "premium pension" system, discussed in the following section, confirm that it is not necessarily good public policy for government to push participation and engagement.

1.4 The Swedish system is a good system, and low cost, but not because of the "premium pension" program; Sweden is a good system because of the "Industrial Model"

Sweden has one of the better performing pension systems in the world – ranked 5th in the 2016 Mercer-Melbourne Global Pensions Index. The Issues Paper refers to the Swedish system, but only to focus on the "premium pension" component. However, the quality of the Swedish system has little to do with the "premium pension," which is a very small part of the system. The quality of the Swedish system is substantially attributable to the fact that it uses the "industrial model" for its 2nd pillar, and the participation of unions and employers.

The key lesson from the Swedish system – which is the only highly regarded system that the Issues Paper refers to – is that industrial parties drive high quality, low cost outcomes.

Researchers attribute the low costs of the Swedish system to the manner in which the occupational pension system is operated:

> Through central procurement of pension products, the social partners [i.e., unions and employers] facilitate low-cost execution of the collective agreements. They centrally organise the administration of the pensions (collection of contributions, choosing where and how to invest contributions) and negotiate conditions with pension providers. As a result, administration and asset management costs are typically low.[21]

In common with most OECD countries the Swedish retirement income system comprises three pillars.

In the first pillar, a contribution rate of 18.5 per cent is allocated by the government between the "income pension" and the "premium pension." The "income pension" receives 16 per cent of contributions and is a notional defined contribution plan that utilises buffer funds and conditional indexation to target and smooth benefits between generations. The "premium pension" receives 2.5 per cent of contributions and comprises individual DC accounts the value of which is determined solely by market returns. In the "premium pension" members can choose between 850 funds.

As the Issues Paper notes, initial enthusiasm for choice in the "premium pension" system has waned significantly since it was first introduced 16 years ago, with most members now defaulting into investment settings decided by the government agency that runs it.

The third pillar comprises voluntary contributions into individual pension savings accounts that are subsidised via tax deductions and which cannot be drawn upon until age 55. In 2012, around 26.4 per cent of the working population held such accounts.

Of the average retirement income in 2012, income from third pillar contributions comprised less than 1 per cent of the total. Income from the government first pillar comprised 78 per cent.[22]

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[21] Bovenberg, L., R. Cox and S. Lundbergh (2015) *Lessons from the Swedish occupational pension system*, Netspar Industry Series, Netspar, Tilburg, p. 33.

[22] Better Finance (2015*) Pension Savings: the Real Return*, p. 316.

The remainder came from the second pillar occupational system. It is the distinctive nature of how this second pillar is structured, owned and governed that helps to explain the efficient nature of the occupational system.

In Sweden, employers are not required by law to offer an occupational pension. However, they must offer one if required by a workplace agreement. Once such an agreement is made, the provisions contained in one of four national collective pension agreements must then be observed. The four pension agreements cover around 90 per cent of the labour force. They are:

i. The SAF-LO agreement, which covers 2.8 million blue collar workers in the private sector;
ii. The ITP agreement, which covers 2 million white collar workers in the private sector;
iii. The KAP-KL agreement, which covers 1 million workers in local government;
iv. The PA-03 agreement, which covers 0.5 million workers in central government.

Two main pension products are offered within the scope of each agreement. The 'traditional product' is a collectively insured DC product in which member contributions buy entitlements to lifetime incomes. All default contributions are made to the 'traditional products.' The 'unit-linked pension product' is open to those who choose to join and who wish to access a greater variety of investment options.

While workers covered by the four collective pension agreements can choose their pension provider, the type of pension product (traditional or unit-linked), the term of the retirement benefit and their insurance, and the product range from which choices can be made is determined by each agreement. The social partners to the agreements (i.e., unions and employers) negotiate with a range of companies and funds to be included as potential providers, with the aim of minimising costs and mitigating the risk of poor choices by non-default members.

The largest product providers included in the four agreements are mutual organisations operated by the social partners. Alecta is the largest default provider in Sweden. It is the default provider for the ITP agreement and is governed by representatives of unions and employers. Others include AMF (also a mutual jointly governed by unions and employers) and Folksam (governed solely by the trade unions).

The administration of the national collective pension agreements in terms of negotiating provider contracts, collecting contributions and distributing them to the default or chosen product providers, is undertaken by organisations also controlled by the social partners. For example, Collectum is the administrator for the ITP agreement and is jointly owned by the Confederation of Swedish Enterprise and the PTK (the peak body for white collar unions in the private sector).

The premium pension system

Although small, there has been some analysis of the "premium pension" system.

As noted in the Issues Paper, the "premium pension" system has experienced a sharp increase in the number of members who rely on the government default. This has occurred notwithstanding that the government "mounted a substantial outreach campaign" and "tried to increase internet accessibility for making choices." Separately "much of the information that was provided by fund managers was overly simplified and even inaccurate."[23]

[23] Weaver, Kent and Alexander Willén (2014), "The Swedish pension system after twenty years: Mid-course corrections and lessons", OECD Journal on Budgeting, Vol. 13/3 at 13-14.

For those few in Sweden who do choose, the evidence is similar to that in Australia and other countries, in that active individual choice is associated with worse outcomes for individuals.[24]

In addition, providing the opportunity for choice has resulted in the growth of an auxiliary financial advisory industry that preys on consumers, especially those on low incomes.[25]

That the Inquiry considered Sweden in connection with preparing the Issues Paper, yet focused solely on the very small "premium pension", and overlooked the evidence of what happened to those who exercised choice, is unfortunate.

1.5 Instead of Chile and New Zealand, the Inquiry should draw on designs from the best funded retirement income systems in the world, which follow the "Industrial Model" for superannuation

Netherlands and Denmark are widely regarded as having the best funded retirement income systems (i.e., 2nd Pillar systems) in the world.[26] They have held this position year after year,[27] and again this year.[28]

The OECD comparisons of private pension systems support these views.

As shown in Table 3, the 2nd Pillar funds in the Netherlands and Denmark *substantially outperform* the funds in New Zealand and Chile on medium and long term nominal net returns, as well as inflation-adjusted net returns. Denmark and the Netherlands also achieve much higher replacement rates and levels of adequacy.

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[24] See id (stating that "First, some individuals pay too much attention to recent fund performance, believing that it is a reliable indicator of future asset performance; they thus overinvest in highly volatile funds or those that have overly concentrated assets. Second, many individuals have a "home bias," overinvesting in domestic assets and with domestic fund managers with whom they are familiar, regardless of that fund's actual performance…Third, individuals may also be susceptible to advertising claims that provide little actual information on the performance of the fund.")

[25] See id., (noting that many individuals appear "particularly susceptible to heavily marketed appeals by financial consultants to take over management of accounts in deals that offer very poor value for money. … There are currently more than 700 000 individuals registered with PPM consultants. The PPM consultancy business is highly profitable, with small PPM consultancy firms having recorded annual profits that exceed SEK 100. A recent report published by the Social Insurance Inspectorate suggests that these services are most commonly used by individuals with low levels of education and income.")

[26] See, e.g., Retirement Income Adequacy Indicator, Allianz, 2015 (noting that "As an overall picture the [Retirement Income Adequacy] indicator ranks pension systems with mature funded pillars in developed countries at the top: The Netherlands are clearly leading the list followed by Denmark and Norway.")

See also, Melbourne-Mercer Global Pensions Index (describing each of Netherlands and Denmark as a "first class and robust retirement income system that delivers good benefits, is sustainable and has a high level of integrity." (Melbourne-Mercer Global Pensions Index, p. 7)

[27] See, e.g., historical Melbourne-Mercer indices.

[28] See, Melbourne-Mercer Global Pension Index 2016.

Table 3 - Private pension funds 5-year and 10-year returns, net replacement rates, and adequacy rankings, selected jurisdictions

Country	5 year average to 2014, % pa [(1)]		10 year-average to 2014, % pa[(1)]		Net Replacement Rate[(1)(2)]	Net replacement rate, Pillar 2[(3)]	Adequacy Ranking[(4)]	Adequacy Ranking (Pillars II/III)[(4)]
	Nominal	Real	Nominal	Real				
Netherlands	9.8	7.8	6.6	4.8	95.7	58.9	1	2
Denmark	8.9	7.1	7.3	5.4	66.4	50.7	2	3
Australia	8.4	6.0	5.6	3.7	55.7	35.4	35	4
Australia: Industry Funds Only	9.0	6.4	6.6	4.8	-	-	-	-
New Zealand	8.6	6.3	5.9	3.3	43.0	14.6[(5)]	10	24
Chile	7.1	3.7	7.1	3.5	35.4	41.7	40	8
Sweden	*No data*				56.0	22.7	8	7

Source: OECD, Allianz, APRA, ISA calculations

Note: (1) OECD (2014), except for Australia: Industry Funds Only, which is based on APRA data (nominal) and ISA calculations (real); (2) Replacement rate is for the year 2014, (3) Replacement rate is for a median income earner for the year 2011, which is the most recent information available, OECD (2011); (4) Allianz (2015); (5) New Zealand's replacement rate is for its "Voluntary DC" Pillar rather than "Mandatory Private" Pillar because the OECD data places KiwiSaver under the former category.

The Inquiry should inform its consideration of alternate default allocation models by reference to Netherlands and Denmark.

Table 4 sets out the key aspects of the 2nd Pillar systems of the Netherlands, Denmark, Sweden, Australia and Chile.

The allocation systems in Denmark and the Netherlands share a lot in common with the default system in Australia, as indicated in Table 4. In particular,

- The 2nd pillar default providers are private, industry or multi-industry plans. They are independent trusts, with their own governance and administrative structures. They are governed by boards that include nominees of employers and unions.[29]
- Products are distributed through the workplace (also see Figure 8, below).
- The default product is determined through either industry-wide or company-level collective agreements between unions and employers (in the case of Australia, the Fair Work Commission nominates default funds, having regard for applications and submissions by unions and employers, as well as providers).

Australia already has a reasonably strong superannuation system, and very strong default system. The Netherlands and Denmark are the only countries that are clearly more highly regarded. The Inquiry has not explained why it is not investigating the two systems that are superior to Australia's, and instead seeking to emulate systems that are given lower regard.

[29] This is substantially the same as the Netherlands. See, Bovenberg, L. and Nijman, T., Developments in pension reform: the case of Dutch stand-alone collective pension schemes, Int Tax Public Finance (2009) 16: 443–467, at 454-55 (stating that "Dutch pension funds are independent trusts with their own governance and administrative structures. The governing board of a pension fund consists of equal representatives of employers and unions.")

Table 4 - Second Pillar Pension Provision, selected jurisdictions

Factor	Denmark	Netherlands	Australia	Chile	Sweden
Melbourne-Mercer index rating 2015	A	A	B+	B	B
Public or private	Public (ATP) and private industry-based plans.	Private industry-based plans.	Public and private industry and multi-industry plans, and private commercial and retail plans.	Private national plans.	Private single and multi-employer plans.
Governance	For private plans, independent trusts with their own governance and administrative structures. The governing board of a fund is appointed by employers and unions. Generally not-for-profit.	For private plans, independent trusts with their own governance and administrative structures. The governing board fund is appointed by employers and unions. Generally not-for-profit.	Independent trusts with their own administrative structures. For award-nominated defaults, the governing board fund is appointed by employers and unions, and not-for-profit. For commercial plans, the board is appointed by the parent company or shareholders.	All are commercial providers with independent trusts and their own administrative structures.	For private plans, independent trusts with their own governance and administrative structures. The governing board fund is appointed by employers and unions. Generally not-for-profit.
Distribution	Workplace distribution of industry and multi-industry funds; some large single corporate funds.	Workplace distribution of industry and multi-industry funds; some large single corporate funds.	Workplace distribution of mainly industry and multi-industry funds; some commercial funds; few large single corporate funds.	Default contributions are made by the employer to the national tender winner.	Workplace distribution of industry and large single corporate funds.
Who chooses and how	The employer default is determined by industry-wide collective agreements between unions and employers.	The employer default is determined by industry and company-level collective agreements between unions and employers.	The employer generally selects from among a shortlist set by industry-wide agreements (i.e. Modern Awards) and enterprise agreements between unions and employers.	All new default contributions must be made to the specified tender winner.	The employer default is determined by industry-wide collective agreements between unions and employers.

Quality filter: How does the country try to ensure that default funds are high quality?	As above.	As above.	Default funds included in Modern Awards must be accepted by an expert panel and the Fair Work Commission	Tender process based on fees.	Inclusion of default funds in national collective pension agreements is decided by the social partners.
Coverage	~90 per cent.	~ 91 per cent.	~90% for Pillar 2; default Pillar 2 coverage at employment of ~70%; retention is more porous. Employees not covered by Awards, EBAs, or state law are not within the default Pillar 2 system; Employees generally can choose their own fund.	~70 per cent.	~90 per cent.
Operating expenses[(1)]	0.2	0.2	1.1[(2)]	1.0	*No Data*[(3)]
Default benefit	Lifetime indexed pension (Mandatory for ATP and for most occupational pension plans).	Lifetime indexed pension.	None.	Annuities or programmed withdrawals.	Lifetime indexed pension.
Method for calculating benefits	Benefits are calculated using actuarial principles, basing the end value on the contributions paid in, the interest rate, average life expectancy and the risk profile of the individual fund.	Contributions buy a pension based on average salary. Entitlements accrue at the same rate regardless of age.	None.	None.	For each contribution, the participant receives a claim to a guaranteed future pension income, based on the interest rate and longevity assumptions at the time of the contribution.

Defined benefit or defined contribution	Collective DC; ATP provides guaranteed (but low) minimum benefits and annual bonuses that depend on investment performance and longevity experience.	Collective DC; Indexation can be suspended. Future payments can be reduced.	DC[4]	DC	Collective DC; Annual indexation of pensions in-deferment and in-payment are conditional on financial position.

Source: Rocha, Vittas and Rudolph (2010); OECD (2015), Pugh and Yermo (2008), Ponds and van Riel (2007), ISA

Note: (1) Average pension fund operating expenses, indexed, Chile = 1.0; (2) This is the expense ratio for all superannuation funds reflected in the OECD data, which includes choice funds; default funds named in awards have much lower expenses; (3) The OECD database does not furnish these data for Sweden; (4) The Australian system is currently not just DC, but also focused on accumulation. As it becomes oriented more toward retirement income provision, it is reasonable to expect greater risk sharing and risk pooling, bringing it closer to more mature retirement income systems.

The Inquiry will be best able to develop evidence-based alternatives to the existing system in Australia by reference to the Dutch and Danish systems.

Assessment of the Dutch and Danish 2nd Pillar default systems has been very strong, and they address exactly the same issues presented in Australia. As explained by two Dutch academic experts on pensions:

> The Dutch pension system consists of three pillars. The first pillar is a pay-as-you-go public pension scheme. It provides a basic flat pension to all older residents at a level that is related to the minimum wage. Compared to other EU countries, the state pension in the Netherlands provides only a relatively small part of pension income for those workers earning middle and higher incomes. If these workers want to maintain their standard of living in retirement, they need additional pension income. This is where the second pillar comes in. The third pillar consists of voluntary personal savings, which are tax favored up to a ceiling. This pillar can be used to tailor the pension portfolio to individual preferences and characteristics, and is especially important for self-employed individuals who lack occupational pension provisions. …
>
> *Adequate defaults* Empirical research shows the importance of defaults (i.e. what happens if people do not choose themselves) in pension insurance. Defaults are important for the premium level, for portfolio selection and for the way in which the pension is paid out. Defaults are so powerful because financially illiterate individuals see the default as an implicit recommendation for a complex product that they do not fully understand. In cooperative pension plans in the Netherlands, the broad portfolio composition and the type of annuity are determined by the board of trustees, while the premium level is set in close consultation with the social partners who negotiate collective labour agreements. The individual members thus cannot opt out of the collective arrangements. In recent years, individuals have been given more individual discretion to select their retirement date and to choose between an individual or a joint-life annuity. Dutch pensions are paid out as annuities because health-care costs are insured through compulsory private and public insurances. Hence, Dutch households face only limited idiosyncratic risks, so that illiquid annuities are an attractive option to insure longevity risk. Cooperative pension plans allow individuals with scarce cognitive abilities to delegate complex saving, investment and insurance decisions to professionals. Collective pension funds assist individuals in properly exploiting their long-run investment horizon and in gaining access to complex investment strategies provided by modern financial markets. More sophisticated life-cycle

investment by pension funds on behalf of long-term investors stabilizes financial markets and facilitates macroeconomic stability.[30]

The infrastructure for the "industrial model" of default superannuation is already in place in Australia, in the form of the Fair Work Commission process and not-for-profit superannuation funds, which were established by industrial parties, and whose governance and culture is influenced by these parties.

In drawing on the experience of Denmark and the Netherlands, the Inquiry should anticipate arguments from those who want a default system in Australia that is dominated by the culture and profit-taking of the financial services sector. These parties will assert that Denmark and the Netherlands are too different from Australia to be relevant, and make references to (i) differences in the degree of savings-based 2nd pillar retirement income versus government-funded 1st Pillar provision of retirement income, (ii) differences in benefit design, specifically that Australia is DC while Netherlands and Denmark are DB, and (iii) differences in union density.

These arguments are not persuasive: these systems share a great deal in common, and the differences that do exist are not a barrier to Australia incorporating aspects of the Danish and Dutch systems.

- *The Netherlands and Denmark have primarily savings-based systems.* The argument that the Dutch and Danish systems are primarily 1st Pillar pay-as-you-go systems, whereas Australia is primarily a savings-funded 2nd Pillar system, is not supported by the evidence. As shown in Table 3, above, over two-thirds of net replacements rates in both Denmark and in the Netherlands arise from 2nd Pillar benefits. It is true that the Netherlands and Denmark have perhaps stronger social safety nets than Australia, but their 2nd Pillars are critical for the retirement wellbeing of most of the population.
- *Benefit design.* The 2nd Pillar systems of both Denmark and the Netherlands are DC or substantially DC systems. According to the OECD: "In Denmark, DB plans constitute a small part (6.6%) of the Danish pension fund market."[31] In the Netherlands, although "official statistics" characterise most plans as defined benefit plans, this is not the case: they are conditional indexation plans.[32] While employers in some plans continue to have some liability to make additional contributions in difficult circumstances, this is declining and these schemes will evolve into DC plans with collective risk sharing.[33, 34]

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[30] Id. at 452, 456.

[31] OECD, Pension Markets in Focus (2014) at 15 (stating that "In Denmark, DB plans constitute a small part (6.6%) of the Danish pension fund market."). See also, G. Impavido, E. Lasagabaster, M. García-Huitrón (2010) New policies for mandatory defined contribution pensions : industrial organization models and investment products, World Bank, Washington, at Figure 1.1

[32] See, Ponds and van Riel (2007), Sharing risk: the Netherlands' new approach to pensions, Center for Retirement Research at Boston College, Brief Number 2007-05 (stating that "Official statistics classify average-wage funds as DB schemes. However, a typical characteristic of these schemes is that indexation of all accrued liabilities is dependent on the solvency position of the pension fund through a so-called 'policy ladder.'")

[33] See, id. (stating that "The hybrid pension plans that have evolved in the Netherlands offer a promising way to balance risk between employers, active workers, and retirees. Going forward, the current hybrid schemes will likely evolve towards collective DC pension plans.")

[34] See, e.g., Ponds and van Riel (2009), Sharing risk: the Netherlands' new approach to pensions, Journal of Pension Economics and Finance (stating that "Traditionally, risk management by Dutch pension funds in the postwar period was done primarily by adjustments in the contribution rate").

See also, Beetsma and Bucciol, Risk Sharing in Defined-Contribution Funded Pension Systems, NETSPAR Discussion Paper 2011-93 (stating that "In many countries, pension systems are under reform (see OECD, 2011), because their sustainability is under threat. … [I]in the Netherlands an increasing number of companies are putting their pension funds at arm's length in order to prevent pension risks from spilling over on to the company's balance sheet. This leads to the so-called funded collective defined contribution (CDC) arrangements.")

Nonetheless, there are significant differences in benefit design between Denmark and the Netherlands, on the one hand, and Australia on the other hand. But that is not relevant to this Inquiry because the matter at hand is how superannuation should be distributed, not its benefit design. In addition, the differences in benefit design may reduce in material respects over time. Australia is expected to transition from a system focused on accumulation to a system focused on delivering retirement income. It remains to be seen what the dominant benefit design in Australia will be. Whatever the design is, it will almost certainly involve risk pooling to a greater degree than is the case today.

- *Union density.* Union density in the Netherlands and in Australia is substantially the same: about 17% in Australia, and about 17.8% in the Netherlands.[35] Union density rates in Denmark are much higher, at about 66% of the workforce.

1.6 A culture based on serving others improves outcomes, whereas competition has not been effective

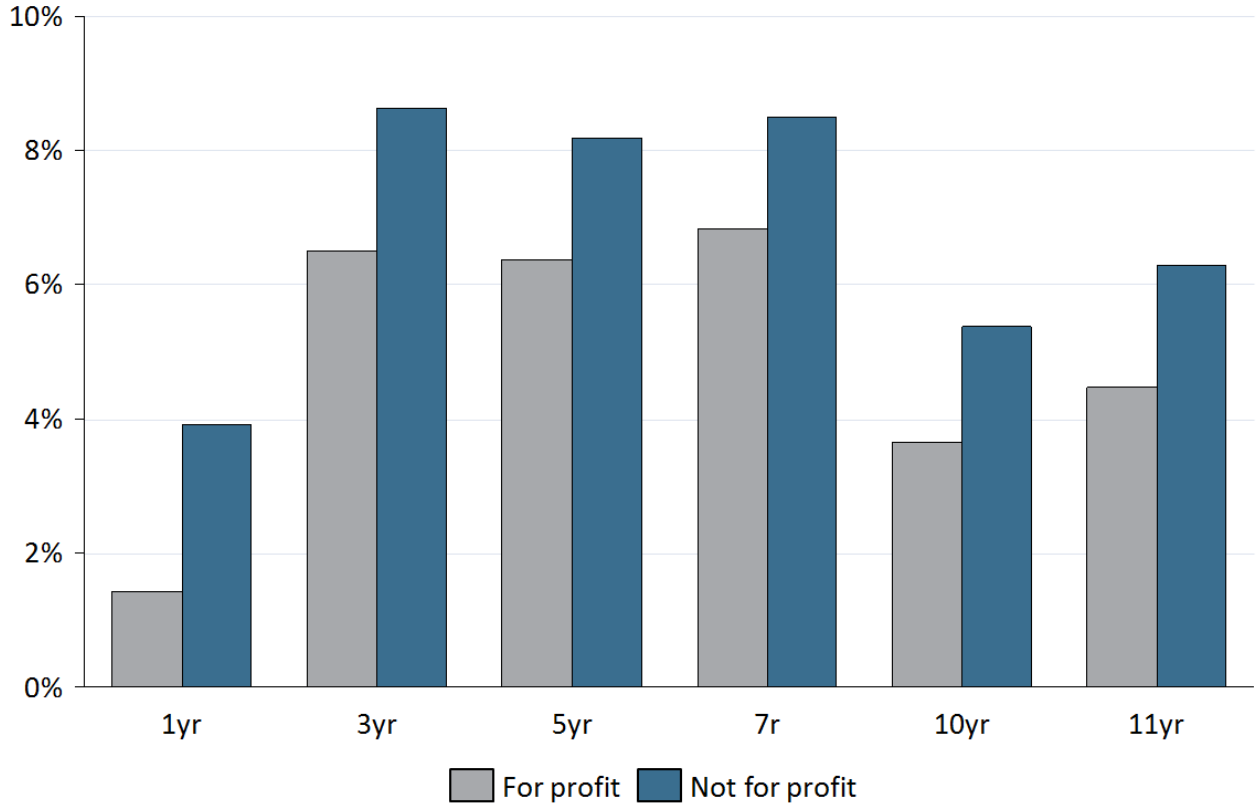
The empirical data regarding Australian superannuation performance shows that culture and values determine outcomes, whereas competition actually has little, or potentially negative, effects on maximising long-term net returns to members.

Consistent with global best practice, Australian not-for-profit super funds were organised to serve members and act in their best interests. This superior organisational impetus and culture has delivered better outcomes for members over the long term. Super funds operated on a not-for-profit basis have substantially outperformed super funds organised to deliver profits to related party and shareholders (Figure 5).

[35] See, OECD.stat, *Trade Union Density*. Figures are for 2013, the last year for which data are available in respect of Denmark, Netherlands, and Australia.

https://stats.oecd.org/Index.aspx?DataSetCode=UN_DEN

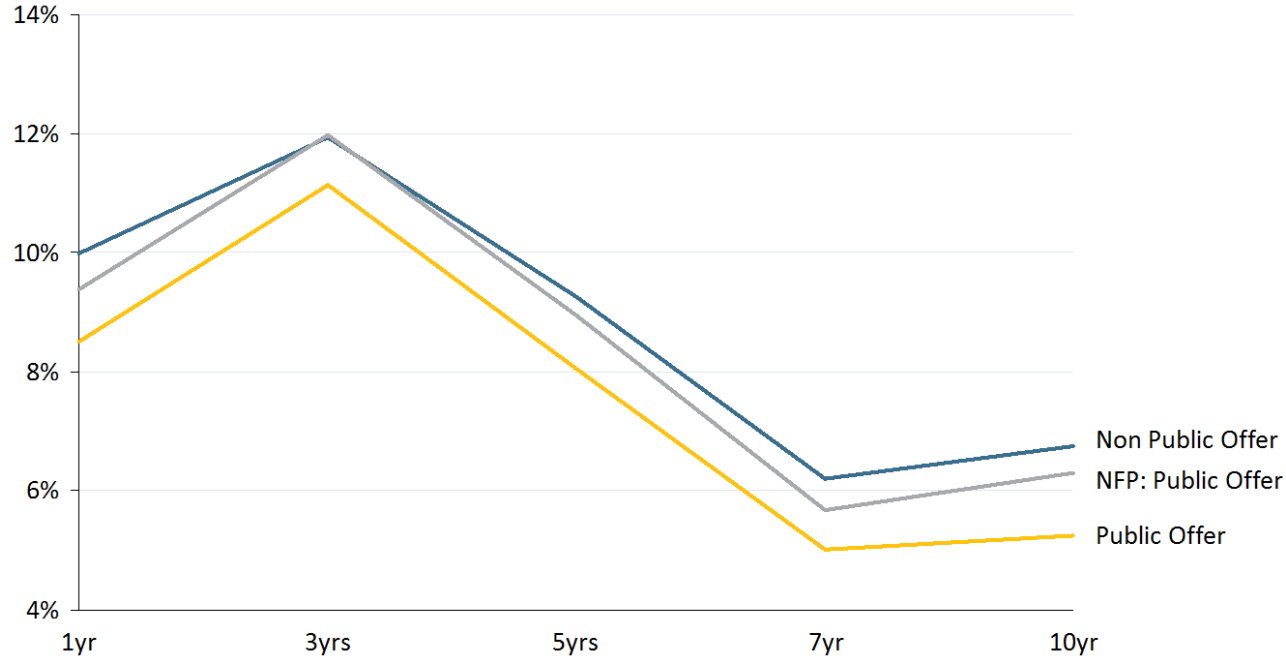
Figure 5 – Net returns, for-profit versus not-for-profit



Source: APRA Quarterly Superannuation Performance, June 2016

Figure 6 shows the long-term performance of non-public offer funds (who generally are not subject to competition) and compares the performance of these funds with the performance of public offer funds (who are subject to competition), and even not-for-profit public offer funds. Over the long term, non-public offer funds outperform public offer funds subject to competition by about 1.5% per year on average. Non-public offer funds outperform even not-for-profit public offer funds by about 0.5% per year on average.

Figure 6 – Net returns, annual average to June 2015



Source: APRA

Note: "NFP: public offer" means "not-for-profit public offer"

The performance differential is likely attributable to higher expenditures by public offer funds on products and services that attract members and employers that do not result in long-term value, higher liquidity requirements for public offer funds, higher employer administration costs, and potentially perverse incentives such as excessive attention to peer risk.

Table 5 shows the difference in fees between public offer and non-public offer funds. Non-public offer funds, typically shielded from competition, have fees roughly half those of the average public offer fund.

Table 5 - Expense Ratios and Annual Per Account Expenses at June 2015

	Investment Expense Ratio, %	Operating Expense Ratio, %	Total Expense Ratio, %
Public Offer	0.20	0.52	0.83
Non Public Offer	0.25	0.21	0.46

Source: APRA

It appears that, funds that compete for employers and members deliver lower long-term net returns and cost more. Even funds who have the right culture tend to have higher expenses when competing.

Competition on the merits

Being selected as a default is a significant responsibility, both legally and ethically, and should involve a very high standard of quality.

Traditional competition theory has assumed that individuals are motived by selfish objectives, and dominated by self-regard; that incentives determine behaviour, not culture, ethics or virtue.

Contemporary research has rejected – and empirically discredited – this view.[36]

1.7 The selection process should be focused on retirement income

The Issues Paper indicated that the Inquiry would "restrict its focus to accumulation products in defined contribution schemes."

The default allocation system developed by the Inquiry should focus on retirement income products rather than accumulation products.

The Cooper Review recommended that the default product in Australia should be a whole-of-life product focused on retirement income provision. ISA supported that recommendation.

Since the Cooper Review, there is consensus among policy makers and industry practitioners that the superannuation system should deliver retirement income.

The Inquiry should not develop alternative models for allocating default members for the superannuation system of the past. The default system should reflect the acknowledged direction of the superannuation system and its underlying objective. Doing otherwise is difficult to explain, other than due to path dependency.

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

1.8 Covered employees – there are good reasons to differentiate by industry

The Issues Paper notes that it does not seem necessary to have different processes for selecting default funds for different kinds of workers or occupations. Instead, different kinds of workers can be allocated to different kinds of products.

We agree, but stress that there are good reasons for allocating different kinds of workers not just to different kinds of products, but also to different providers. Different workers operate under different employment conditions and environments. For example, although impersonal or electronic communication-based approaches are perhaps the norm, it remains the case that some workers are on ships, or in other remote worksites. Providers that are familiar with and connected to industries can and do accommodate industry-specific needs in ways that a generic provider cannot, regardless of how that provider structures its products.

Most industry funds have pro-active compliance programs in industries such as construction, designed to ensure that employers comply with their legal obligations to pay SG contributions in full and on time. Some industry funds have a focus on mental wellbeing insofar as workers in their industry are prone to mental health issues. Some funds specifically tailor their offering based on member demographics in the industry, extent of flexible work patterns, education standards/qualifications, ethnic background, and other factors.

For example, funds with younger demographics and/or lower account balances have tailored insurance arrangements by assessing the affordability of insurance cover against the adequacy of cover. Funds where the demographics are predominantly a cohort of blue collar members have tailored benefit design, definitions and rehabilitation services to support musculoskeletal claims. Funds relating to occupations and industries that are more prone to mental health issues have established insurance arrangements and services that seek to prevent and rehabilitate such members. Funds where members work in industries such as health and education have offered socially responsible investment options consistent with the values of the industries they serve. Funds with ageing members and higher account balances have allocated more of their scarce resources to retirement matters, pension products and comprehensive financial advice offerings.

Communications and methods of communication are also influenced by the demographics of industries so that funds can deliver more effective services to members.

Similarly, products and ancillary benefits often are designed based on, or take into account, member demographics. Insurance arrangements for workers with common risk factors also can be obtained with greater efficiency (see Section 1.13).

Having different products for different kinds of workers remains important and the importance may increase. As retirement income benefit designs become more developed, mortality risk pooling will become more common. While it is possible in principle to have mortality pools with diverse cohorts, provided the pricing is fair, it is not clear that pools reflecting national diversity would necessarily be the most practical or easy to maintain fairness.

1.9 Government incentives in a selection process without industrial parties can lead to perverse outcomes

The Inquiry should give regard to the behaviour of governments in tender processes. Governments undertaking singular responsibility for determining default funds run a high risk.

In KiwiSaver, the New Zealand government took upon itself the role of selecting default funds. It did not involve employers or unions to provide credibility to the process. As a result, researchers at the University of Auckland concluded that the government operated the tender process to reduce the government's exposure to risk, not to prioritise member's best interests:

> [The tender process] wasn't about the capability to deliver KiwiSaver to the benefit of members; rather it looked as though the aim was to reduce the government's exposure to risk. That may have been a reasonable basis to protect the government's interests but in this case, the members' best interests were not necessarily aligned with the government's.[37]

In Australia, the Fair Work Commission acts as the default fund and product selector, and is independent of government. Moreover, the selection process is informed by the participation of unions and employer groups, who are often described in other countries as the social partners. Under the current default system, the risk to government is thus very low, which enables the default selection process to focus on merit.

1.10 The Fair Work Commission as a forum for the selection process

The agency that conducts a process is potentially as important as the process itself. "People are policy." An institution's heritage and stakeholders affects how it analyses and addresses matters.

The Issues Paper says little about how the Inquiry will evaluate where the selection process will be undertaken.

The Fair Work Commission process has certain elements that have helped its success.

- *Capacity to contemplate a range of factors*. Where the selection process must contemplate a range of factors, with a focus on net benefits rather than cost, the capacity of the Fair Work Commission to receive arguments and evidence from a range of parties, and for claims to be tested in an adversarial format, is useful. The Commission operates as a tribunal. The adversarial mode used by the judicial system is how complex matters are contested, and resolved, in a manner that maintains the confidence of the public.
- *Transparency*. Arguments and materials are accessible to the public, consistent with the Fair Work Commission's status as a tribunal. In this capacity, the Fair Work Commission must hold open hearings,[38] and publish the reasons for its decisions.[39]
- *Probity*. Adversarial testing enables the arguments of different providers seeking to be named as default funds to be examined by those with the information and motivation to challenge them, as well as subjecting them to the scrutiny of an expert panel and tribunal.
- *Independence and impartiality*. Members of the Fair Work Commission "have the same level of independence" as justices of the federal courts. The Fair Work Commission "is required to … determine the matters that come before it impartially."[40]

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[37] Retirement Policy and Research Centre, University of Auckland Business School, Submission on the Review of KiwiSaver Default Provider Arrangements, December 2012.

[38] Other than in limited circumstances pursuant to Section 593(3) of the Fair Work Act.

[39] See, Fair Work Australia, Submission by Fair Work Australia to the Review of the Freedom of Information Act, 2012.

[40] See id., citing *R v Commonwealth Conciliation and Arbitration Commission; ex parte Angliss Group* (1969) 122 CLR 546 in relation to the predecessor tribunal, and noting that the principle was affirmed with respect to Fair Work Australia, citing *Coal & Allied Mining Services Pty Ltd v Lawler* [2011] FCAFC 54 per Buchanan J (with whom Marshall and Cowdroy JJ agreed).

- *Procedural fairness and treatment of parties*. The Fair Work Commission is subject to common law principles of procedural fairness, underscored by the requirement that the Fair Work Commission act "judicially."[41]
- *Participation of industrial parties*. The participation of industrial parties has had a number of beneficial effects. As noted above, the participation of industrial parties frees government from certain risks. In addition, industrial parties have interests in common with beneficiaries and well-established cultural norms in the context of superannuation that prioritise beneficiaries. They do not have material interests or conflicting profit motives adverse to beneficiaries. With respect to trade unions, there is a significant body of evidence which shows unionisation is strongly associated with better pay and conditions for workers. Employers do not have adverse interests to workers in respect of superannuation provider because the commercial results of employers cannot be improved by extracting value from employees. In fact, employee retention and productivity can be improved where superannuation is well-managed.
- *Resistance to finance sector capture*. Employers and employees are important stakeholders in the system and have interests in the outcomes of selection processes. A process conducted outside of the Fair Work Commission would, as a practical matter, come to focus almost exclusively on superannuation providers, and rely solely on government and regulators to protect the public interest.
- *Superannuation is an employment entitlement at law.* Conducting the selection process within the Fair Work Commission is necessary to respect that superannuation is an employee entitlement, has the character of wages, and is under the jurisdiction of the industrial system. As the High Court has explained "Entitlement to participate in a superannuation scheme and the means by which that scheme is to be funded are matters which pertain to the relations of employers and employees and fall within" a number of provisions of the industrial relations laws.[42] Superannuation emanates from the industrial wages system; it has the character of deferred wages. As a practical matter, superannuation contribution levels and the workplace default fund are frequently the subject of enterprise bargaining because they are matters of interest to employers and employees, as well as being addressed by most modern awards.

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[41] See id.; see also, Fair Work Commission, Practice Note: Fair hearings, available at:

https://www.fwc.gov.au/resources/practice-notes/fair-hearings

[42] See, *Re Manufacturing Grocers' Employees Federation (Aust); Ex parte Australian Chamber of Manufacturers* (1986) 160 CLR 341, 355-356 (stating that "It may be observed generally that superannuation benefits are commonly regarded as being an aspect of the terms or conditions of employment, being in many circumstances in the interests of both employer and employee. ... As a matter of common understanding, entitlement to participate in a superannuation scheme and the means by which that scheme is to be funded are matters which pertain to the relations of employers and employees and fall within pars. (b) ["the privileges, rights and duties of employers and employees"], (c) ["the wages, allowances and remuneration of persons employed or to be employed"] and (h) ["the mode, terms and conditions of employment"] of the definition of industrial matters in s. 4 of the Act.").

As interpreted in the *Melbourne University Law Review* [Vol. 15, December 1986] at 754: "In this case the High Court expressed the view that 'as a matter of common understanding superannuation benefits could be regarded as an aspect of the terms and conditions of employment being in many circumstances in the interests of both employers and employees. *Superannuation payments were an integral part of the employer-employee relationship* even though the benefit is deferred until after the employment relationship has ended."(Emphasis added).

The position was reaffirmed by the High Court in *Re Amalgamated Metal Workers Union of Australia; Ex parte The Shell Company of Australia Ltd* (1992) 174 CLR 345 at 356.

The protections of the industrial model should be extended

Employees covered by modern awards and enterprise bargaining agreements are well-looked after.[43] However there are limitations to the extension of these protections.

Employees who are not covered by the industrial model instead must rely on MySuper. Others have acknowledged that MySuper is inadequate because it does not involve a quality filter.

In addition, although many employees initially join the workplace default, there is significant movement from the high performing default sector into lower performing choice funds and self-managed super funds.

1.11 The selection process should be undertaken by an agency outside of financial services due to the risk of regulatory capture, and potentially conflicting priorities

Australia's "twin peaks" regulatory structure is highly regarded. ASIC and APRA are effective. The IMF's review of Australia's regulatory arrangements found they were of high quality:

> The financial regulatory and supervisory framework exhibits a high degree of compliance with international standards… The principles-based and outcome-oriented supervisory approach of APRA is effective, with notable strengths in risk analyses embedded in the PAIRS and SOARS system, industry-wide risk assessments, and a focus on bank boards' responsibility for risk management. ASIC is also a highly regarded enforcer of market regulation.[44]

Disruption to Australia's effective regulatory architecture would be undesirable.

When considering the appropriate venue for any default superannuation fund selection process, the Inquiry should give careful regard to how doing so might adversely affect our regulators.

There are two main risks that could emerge if a financial regulator were tasked with selecting default funds: (i) regulatory capture and (ii) potentially conflicting priorities.

The risk of regulatory capture by for-profit companies is a longstanding concern.[45]

The risk of regulatory capture is heightened in the area of financial services for a number of reasons, including that the "vital interests" of financial corporations are at stake in regulation; other interests in the financial systems, such as consumers, are diffuse and lack organisation; career opportunities; and, because financial regulation involves a relatively small and tightly woven social group focused on relatively complex issues, a culture of co-operation, informal cultural exchange, and shared world view, can emerge.[46]

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[43] However, there are concerns that some employers may be unaware of the application of the superannuation requirements under a modern award, or the requirements are not sufficiently enforced.

[44] Financial System Assessment Program, Australia: Financial System Stability Assessment, IMF Country Report No. 12/308 (2012) at 1 and 6.

[45] See, Stigler, G. (1971) 'The Economic Theory of Regulation', Bell Journal of Economics and Management Science, Vol. 2 (arguing that concentrated producer groups are able to systematically exercise a disproportionate influence over the conduct of their regulators to the point of shaping regulation to suit their interests rather than their mandate to maximize social welfare.)

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

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

The Inquiry should ensure any new allocation system is not undertaken by a financial services regulator to reduce the risk of regulatory capture. This is one of the reasons why the Fair Work Commission is an appropriate venue for the selection process.

In addition, adding default fund selection to the responsibility of one of the financial services regulators in Australia would be inconsistent with the "twin peaks" model. The "twin peaks" model, which separates conduct regulation and prudential regulation, is based on the Tinbergen principle, which requires focused instruments of policy. Adding a new policy goal – default super fund selection – could place tension on the regulators' capacity to perform their core mission.

For example, if ASIC were tasked with selecting defaults, it may suffer internal tension if considering an enforcement action against a default fund that it had selected.

Selecting default funds also could jeopardize APRA's capacity to function in two respects. First, prudential regulation exists to ensure that reasonable standards of safety and soundness within institutions are maintained so that the public and customers can have an appropriate level of confidence that the entity will be able to honour its obligations. Prudential regulation must not pick "winners and losers." Second, prudential regulation generally requires an openness and candour between the regulated entity and the regulator. It is conceivable that a prudentially regulated entity might be reluctant to alert APRA of a prudential concern if there was a risk that doing so would prejudice the default selection process.[47]

To be clear, there is no suggestion that ASIC or APRA are captured regulators. Instead, the risk of capture increases if a financial services regulator is tasked with selecting default superannuation providers. Many for-profit providers see such members as a potentially lucrative source of revenue.

1.12 Corporate tenders are not a good precedent for designing a selection process

Assessment of the quality of corporate tenders as a device for improving superannuation efficiency is challenging because of a lack of transparency about tender criteria, processes and outcomes.

However, the anecdotal evidence available suggests that the process lacks uniformity, promotes a race to the bottom in relation to fees, is time consuming and costly, and may be undermined by a conflict of interest between the corporate tender consultant/employer and the successful fund.

Several very large Industry SuperFunds report that they regularly participate in corporate tenders, participating in between six and twelve tenders per year depending on the fund.

The experience of these funds is that the characteristics of employers who run corporate tenders vary considerably. Small, medium and large employers in the private and public sectors run corporate tenders.

Reflecting this diversity, employers adopt different approaches to the tender process. For example, some employers run tenders internally – typically, this is the responsibility of the HR or finance function. More recently, some employers task their procurement function with running tenders.

[47] This is one of the reasons why prudential regulators generally do not undertake enforcement actions or otherwise publicly admonish entities for self-reporting prudential matters. APRA's policy on enforcement action is consistent with this. See, APRA, Fact Sheet 6 (Stating that "The Australian Prudential Regulation Authority (APRA) prefers to take a cooperative approach to resolving prudential issues with boards and management of the institutions it supervises. … On occasions, APRA's collaborative approach will be unsuccessful either because the institution it is supervising is not willing to cooperate or is unable to do so.")

Other employers engage tender consultants. There are many tender consulting firms, ranging from the large accounting and consulting firms to small financial advice practices. Some companies retain a consultant to assist in choosing a tender consultant. The extent to which employers provide oversight of the work of consultants also varies considerably.

Tenders typically focus mainly on performance and fees, as well as insurance, investment strategy, administration and member services, although these criteria are generally allocated less weight. Particular employers may also require funds to address other issues, for example corporate governance.

There are a number of problems with the manner in which corporate tenders operate.

- *Conflicts of interest*. Some tender consultants extract benefits from funds appointed as a result of tender processes. There are known instances in which a tender consultant (or a related entity of a tender consultant) received a fee per member from the fund for the provision of other services to the fund.
- *Lack of transparency.* Funds applying or appointed under corporate tenders are not required to publicly disclose the performance and fees provided under these arrangements.
- *Inducements and cross-dealing.* Following some corporate tenders, a fund is selected with which the employer has an association. For example, the fund is part of a corporate group which: (i) is also a key client of the employer, or (ii) provides other services to the employer, such as banking.
- *Costs*. Tender processes involve significant costs for both the employer and the fund, and consume substantial resources across organisations. For example, one very large Industry Super Fund reports submitting tenders that run more than 140 pages.
- *Loss leading and flipping.* Some super funds offer fee discounts as part of a corporate tender. The objective is to secure the member so that upselling can be undertaken, or on the expectation that many of the members will cease employment with the employer, enabling the fund to flip the member into a higher-fee fund. This practice is particularly attractive in relation to large employers with high staff turnover, such as large retailers. Although prohibited by rules enacted in connection with MySuper, these practices persist, prohibitions are nearly impossible to enforce, and are unaffected by tender process design.

1.13 No rationale for the Issues Paper position on insurance

The Issues Paper indicated that all default models proposed by the Inquiry would exclude insurance, and that "the life and total and permanent disability insurance that is currently bundled with default superannuation products would then be allocated through a separate competitive process."[48]

The Issues Paper does not provide any rationale for the Inquiry's preliminary view. As a result, the public will struggle to comment on it, other than to generally explain why insurance is appropriate within a default fund.

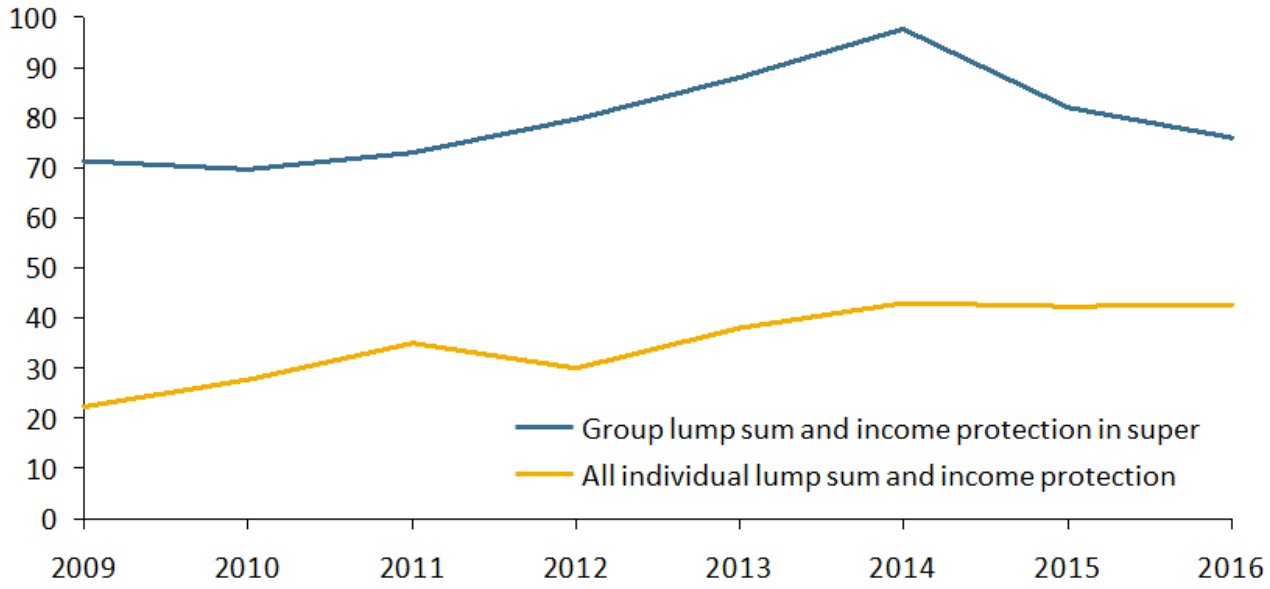
Moreover, the nature of the default selection process developed by the Inquiry might be more or less suitable for inclusion of insurance. If the Inquiry ultimately determines to recommend a national, frequent auction for future cohorts of default members based, say, on age, it might not make sense for insurance to be included. However, it would be surprising for the Inquiry to recommend such a process because the empirical evidence would not support it. If the Inquiry recommended a selection process that grouped cohorts using factors relevant to mortality (which would be sensible because these factors are relevant to delivering retirement incomes/pensions), then providing other kinds of insurance would be efficient.

[48] Issues Paper at 10.

Since the rationale for the Inquiry's preliminary position was unclear, we note that there are reasons to include insurance in the superannuation default via a preferred provider:

- *Cost effectiveness through group approaches*. Through the pooling of lives under a group policy, insurers can more effectively price risk.
- *Value for money*. Not-for-profit trustees have sought to obtain good value for money in the provision of insurance in superannuation. This is clear from the difference in payout ratios, as indicated in Figure 7, which shows the difference in payout ratios between group insurance and individual insurance (combined life, disability, and income protection).

Figure 7 – Insurance claim ratios, %



Source: APRA

Note: The claim ratio compares the net policy revenue to the net policy expenses for claims paid taking into account the effective movement in net policy liabilities reported to APRA

- *Efficiency and ease of administration.* Typically, funds have one insurer and remit premiums accordingly. Having multiple insurers would increase administration costs and complexity in the payment of premiums, determining which policy to apply when underwriting, assessing claims, commencing and ceasing insurance and determining the value of cover.
- *Reduced adverse selection risk* due the guidance of the default.

Efficient risk sharing and risk pooling. People in different industries have different risk profiles for many insurance purposes. For example, there are clear differences in on-the-job risks to health in different areas of work.

- Table 6 presents the number of serious claims and rates of serious claims for work cover purposes in 2013-14, demonstrating significant variation among industries.

Table 6 - Number and rates of serious claims by industry, 2013–14

Industry	Number of serious claims	Frequency rate[1]	Incidence rate[2]
Accommodation and food services	6,155	6.3	7.8
Administrative and support services	4,525	6.5	10.5
Agriculture, forestry and fishing	3,365	8.6	17.4
Arts and recreation services	1,865	7.3	9.2
Construction	11,535	7.2	14.7
Education and training	6,025	4.2	6.5
Electricity, gas, water and waste services	1,100	3.9	7.5
Financial and insurance services	685	.09	1.7
Health care and social assistance	17,415	8.7	12.5
Information media and telecommunications	575	1.7	3.0
Manufacturing	12,930	7.9	15.0
Mining	2,670	4.6	10.4
Other services	3,370	4.9	8.6
Professional, scientific and technical services	1,665	1.1	2.1
Public administration and safety	8,775	6.9	11.7
Rental, hiring and real estate services	965	2.8	5.0
Retail trade	8,975	5.4	7.3
Transport, postal and warehousing	9,425	9.3	17.4
Wholesale trade	4,380	6.1	11.6
Total	106,565	5.9	9.8
Variance in rates		0.9-9.3 (96.7%)	1.7-17.4 (97.7%)

Source: Safework Australia, Australian Workers' Compensation Statistics, 2013-2014; ISA calculations of variance in rates

Note: Frequency rate = serious claims per million hours worked; Incidence rate = serious claims per 1000 employees.

- *Scale*.

- *Trustee-level judgment*. In addition to well-known differences in mortality in different industries (both during work and in retirement), different industries have other risk characteristics that can make industry-tailored coverage efficient and beneficial to wellbeing. For example, industries have different probabilistic risks of permanent versus temporary disability. As a result, reasonable trustees have bargained for different kinds of coverage. Some examples include: (i) extended waiting periods for TPD, combined with longer income protection, such that income protection provides support for a period of time to enable rehabilitation prior to a determination of whether disability exists, (ii) the removal of waiting periods in TPD insurance to encourage early notification, and (iii) mental health programs targeted at occupations that are prone to higher levels of work related stress and mental health issues.

- *Clarity about how premiums would be paid and other administrative matters*. Currently, a portion of superannuation contributions are allocated to insurance. Trustees are responsible for paying premiums and securing coverage, with the involvement of industrial parties taking into account the nature of the industry. If a separate process were established, administrative processes would need to be reviewed

and new ones established. Reasonable and appropriate heterogeneity in practices and coverage might not survive a standardised process. It is unclear that policy makers will want to stand in the shoes of industrial parties and employers to specify insurance coverage from superannuation contributions. It also is unclear that policy makers are better able to make these judgments.

- *Reducing underinsurance.* Group life insurance plays a critical role in redressing the underinsurance issue in Australia. Current default settings use an opt-out arrangement, which provides valuable protection to members (and their beneficiaries) in the event an unfortunate incident occurs. It is estimated that the group policies represents approximately 70 per cent of death and TPD policies written. Removing this safety net from the superannuation default arrangements and at the discretion of the Trustee could place additional burden on the public and social safety nets. Both group life insurers and superannuation funds are subject to regulation by APRA and ASIC, which provides monitoring and supervision of the activities of all the relevant entities. Without understanding what the alternative model would look like, it is difficult to identify and quantify whether a better outcome can be achieved.

2. Discussion of selection process evaluation criteria

How default products are selected is important to the wellbeing in retirement of members, and the Commonwealth fiscal position.

A default fund selection process should, first and foremost, be one which has a very high likelihood of most efficiently delivering benefits in the best interests of members. This means meeting the universal need of people covered by a 2nd pillar system, namely providing the maximum amount of reliable retirement income per dollar of employer contribution, member contribution, and government contribution.

In practice, this involves selecting funds that will maximise long-term net returns, and the appropriateness of the fees and costs, governance, insurance, advice services, administrative efficiency, and any other matters the Fair Work Commission considers relevant.

Taking into account the limitations of any selection process – such as the capacity to use the selection process to discipline default providers will not match the length of time that the providers will look after a member – evaluating alternatives in terms of achieving members' best interests should involve consideration of the values and culture of providers. Not just their incentives under the selection process.

As a result, we agree in substance with the Inquiry's proposed first criteria for evaluating selection processes, namely "members' best interests," and suggest this criterion should be enhanced to consider the values and culture of providers.

Members' best interests could arguably be the sole criterion for evaluating selection processes, since selection processes that are strong on the other criteria, but weak on members' best interests, would be difficult to justify. Moreover, systems that have high integrity, and low system wide costs, for example, should be more efficient in securing members' best interests.

Should the Inquiry wish to include additional criteria, the Inquiry should clearly articulate how they would be weighted.

We also have comments on some of the other proposed criteria.

Competition. The Issues Paper suggests that the second criterion is competition. The Commission has elsewhere noted that competition is always only a means, not an end. Competition can be effective, but it also can be ineffective.

While a good selection process need not involve competition, it is essential that any selection process sets a very high bar, and ensures that only the best performing super funds are eligible to receive default savings. A rigorous process will result in pressure akin to competition, as funds that wish to be named as defaults rise to meet the challenge. Importantly, many funds will do so because of a desire to provide the best service to members, not due to self-interest or to maximise the interests of shareholders.

Integrity. The Issues Paper suggests the third criterion is integrity. We agree that integrity is important. In evaluating integrity, the Inquiry should also give regard to:

- The risk of regulatory capture to the integrity of the selection process.
- The risks to integrity of the superannuation system of significant movement of members and assets from default providers into lower quality products.
- The risks to integrity and confidence in a system from the participation of providers who have poor culture.
- The risk of potential conflicts arising due to related party transactions, inducements or commissions in the provision of services or products.

Stability. We agree that stability is an important consideration, because it can affect confidence and trust in the system. Stability can also enhance the ability of default providers to invest for the long term in illiquid assets due to greater certainty regarding cash flows.[49] The current system has existed for over two decades.

System-wide costs. Instead of costs, this criterion should focus on efficiency. Government and members should receive the greatest financial benefits for the funding placed under the custody of the superannuation system. System wide costs should consider opportunity costs for investing in short term or liquid instruments that might arise from frequent selection processes.

Additional criterion

The Inquiry should give strong regard to *practicality* as a factor. Could the process reasonably be implemented with limited disruption or risk? Has it been implemented successfully in any reasonably comparable context?

In assessing alternate models, the Commission should also have regard to the following matters:

- Liquidity considerations and the implications regarding investment,
- Minimising the risk of lost and inactive members,
- Minimising the risk of duplicate accounts, and promoting consolidation of accounts,
- Leveraging existing infrastructure,
- A robust default system should seek to protect members from self-harm and irrational behaviour, and
- Minimising the risk of non-compliance with SG requirements.

[49] However, whether a fund utilises these cash flows to improve member outcomes depends on culture and values. There is a significant for-profit fund presence among the funds named in modern awards, and these for-profit funds do not have asset allocations like industry super funds or the Future Fund.

3. Our default system

Most workers are defaulted into a product by their employer, often under the direction of an industrial instrument such as a modern award or enterprise bargaining agreement.

For nearly 25 years the large majority of working Australians have been required by law to make contributions to privately operated superannuation funds.

The need for mandatory superannuation contributions as the second pillar of our retirement income system arose from the growing awareness among unions, employers and the then government that fiscal expenditures and voluntary private savings were unlikely to be able to provide future standards of living in retirement conducive to expectations and minimum community standards for most working Australians.

In a context where levels of voluntary savings were low, and exhortations to increase them were unlikely to result in significant behavioural change, democratic institutions mandated that most employees make contributions over the course of their working lives.

To implement a funded retirement income system, mandating savings is not enough. For the reasons outlined below, public policy needs to connect savings to high quality providers and products.

That nearly all employees are required to make contributions to privately operated superannuation funds has given rise to a 'market' for superannuation with a number of important distinguishing features:

- *Participation by consumers pursuant to democratic rather than market forces, in response to a recognised need for a funded retirement income, with most consumers lacking the resources and inclination to make informed choices and are therefore characterised by inertia and passivity*. While most workers have the right to exercise individual choice very few actually do so. Around 3 per cent of superannuation fund members switch funds each year. Around half of these do so only because they change their employer. Over 90 per cent of fund members do not take the opportunity to switch between investment options and therefore remain in the default investment option.[50]
- *Cognitive factors*. In addition to protecting the interests of those who are disengaged, default settings act as an anchor point for the consideration of those who are engaged.
- *Significant information asymmetry between most fund members and superannuation institutions and related professionals such as financial advisors*. To millions of Australians superannuation appears dauntingly complex and opaque. The proliferation of products and investment options, far from engaging and empowering customers, has often reinforced the image of an industry beyond the understanding of most working people. 'Choice overload' in the context of limited financial literacy tends to reinforce consumer passivity and inertia. For many, the time and costs involved in acquiring sufficient knowledge to make informed decisions about fund and investment choices are too great and too daunting.[51]
- *The existence of multiple conflicts of interest*. Many of the superannuation funds that offer superannuation products and services do so for the primary purpose of generating profits for related parties, such as the large retail banks that own them. The existence of a large number of customers who are compelled to participate in a 'market' they do not understand or engage with, and so cannot shape in their interests, has provided some institutions such as retail superannuation funds and their

[50] Industry Super Network (2010) Supernomics: Addressing Failures of Competition in the Superannuation Market.

[51] Fear, J. and G. Pace (2008) Choosing Not to Choose: making superannuation work by default, The Australia Institute, Discussion Paper 103.

corporate parents with significant opportunities to accumulate profit by a range of means, which directly contribute to generating poor retirement outcomes for members. These means include: charging high fees for the super product and related products such as insurance; paying high charges to related corporate entities for services such as investment management; and investing in low cost passive asset allocations that maintain margins, but contribute to generating poor retirement outcomes for members.

- *Sales-driven switching*. Among those who do intentionally switch funds, this is substantially attributable to the sales efforts of vertically integrated for-profit providers. This was initially undertaken via financial planning networks. Since the Future of Financial Advice Reforms, for-profit providers are increasingly using "general advice" direct institutional sales (i.e., cross-selling of superannuation by bank staff).[52]
- *Inducement in the wholesale market*. Whilst various legislative protections are in place to promote the best interests of members and prevent inappropriate behaviour such as inducement or misleading conduct by providers toward employers, there is little evidence to suggest such protections are routinely enforced.

That the processes by which most workers join and contribute to a default fund does not function as a 'market' is evidenced by the fact that while retail funds have on average underperformed relative to most not-for-profit industry funds in terms of net returns to members, they continue to secure a substantial part of the industry, and charge significantly higher fees or margins.[53]

A robust default system should seek to protect members from self-harm and irrational behaviour.

The quantum and sources of the outperformance of industry funds will be discussed in more detail below.

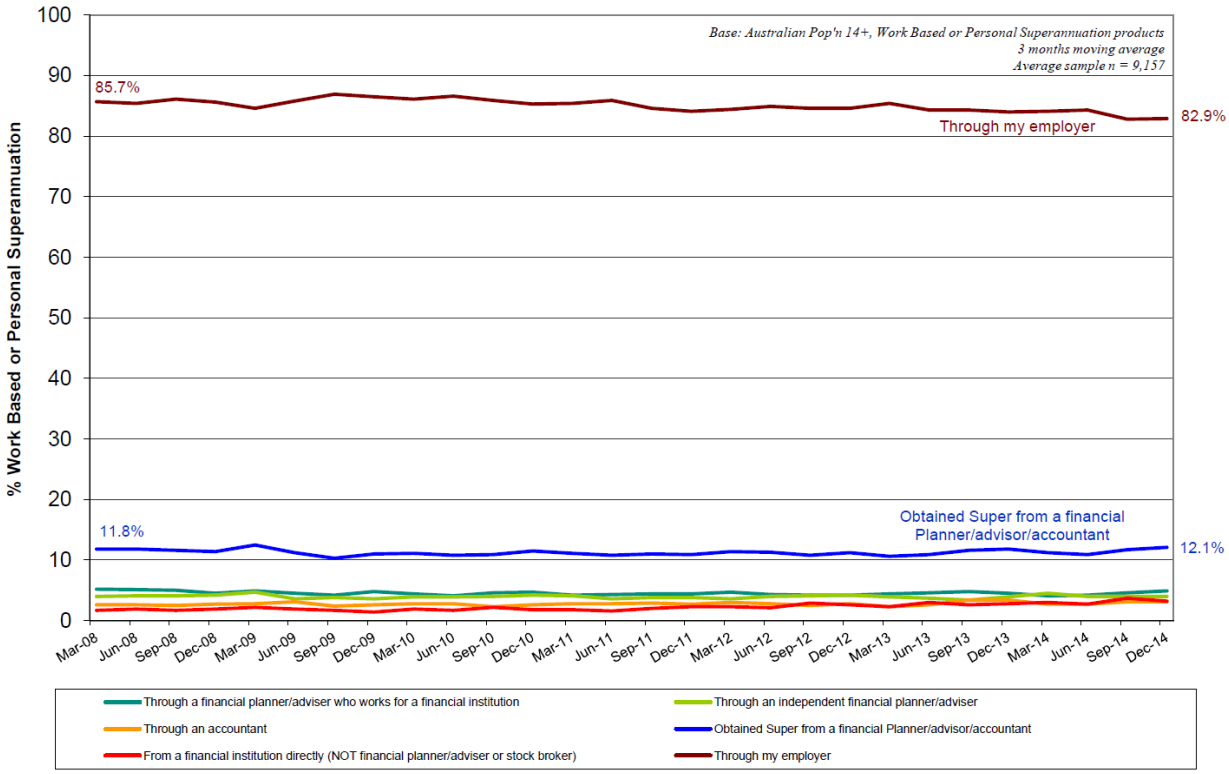
A consequence of this distinctive set of structures and process is that most workers make contributions to superannuation products that they are defaulted into via the industrial instruments (modern awards and enterprise bargaining agreements) that apply to their industry or workplace. This is illustrated by Figure 8.

[52] See, Industry Super Australia, *The Hard Sell*, 4 October 2016, at Figure 1 and related text (analyzing Roy Morgan Research for switching channels), at:

http://www.industrysuperaustralia.com/assets/MediaRelease/160904-The-Hard-Sell.docx.pdf

[53] Liu, Kevin; Arnold, Bruce; Australian superannuation outsourcing: fees, related parties and concentrated markets, APRA Working Paper, November 2010; Minife, Super Sting, Grattan Institute April 2014.

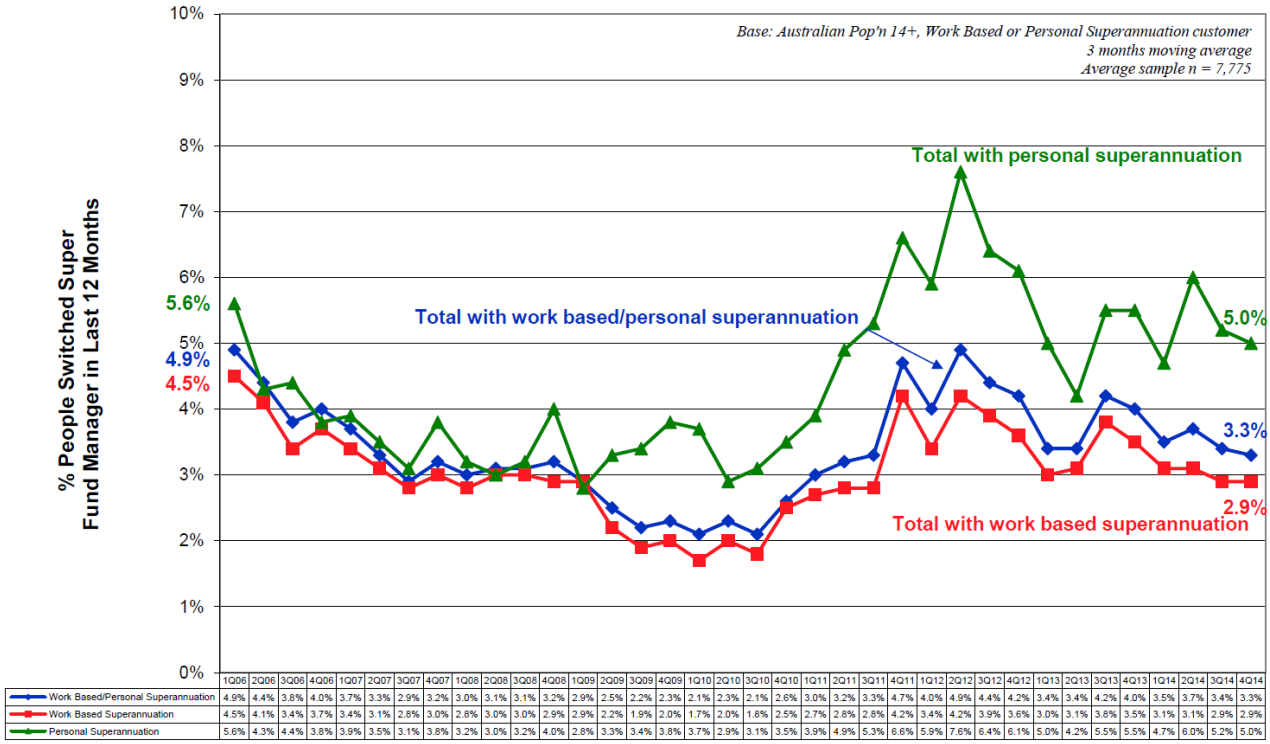
Figure 8 – over 80% of people enter their superfund through the workplace



Source: Roy Morgan Research (2015)

Moreover, once they are in a workplace superannuation product, most do not switch into choice products. This low level of switching is illustrated by Figure 9.

Figure 9 – Switching is low



	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14
Work Based/Personal Superannuation	4.9%	4.4%	3.8%	4.0%	3.7%	3.3%	2.9%	3.2%	3.0%	3.1%	3.1%	3.2%	2.9%	2.5%	2.2%	2.3%	2.1%	2.3%	2.1%	2.6%	3.0%	3.2%	3.3%	4.7%	4.0%	4.9%	4.4%	4.2%	3.4%	3.4%	4.2%	4.0%	3.5%	3.7%	3.4%	3.3%
Work Based Superannuation	4.5%	4.1%	3.4%	3.7%	3.4%	3.1%	2.8%	3.0%	2.8%	3.0%	3.0%	2.9%	2.9%	2.2%	1.9%	2.0%	1.7%	2.0%	1.8%	2.5%	2.7%	2.8%	2.8%	4.2%	3.4%	4.2%	3.9%	3.6%	3.0%	3.1%	3.8%	3.5%	3.1%	3.1%	2.9%	2.9%
Personal Superannuation	5.6%	4.3%	4.4%	3.8%	3.9%	3.5%	3.1%	3.8%	3.2%	3.0%	3.2%	4.0%	2.8%	3.3%	3.4%	3.8%	3.7%	2.9%	3.1%	3.5%	3.9%	4.9%	5.3%	6.6%	5.9%	7.6%	6.4%	6.1%	5.0%	4.2%	5.5%	5.5%	4.7%	6.0%	5.2%	5.0%

Source: Roy Morgan Research (2015)

That our superannuation system mandates contributions by workers most of whom do not actively choose which funds to join, in a context where many for-profit providers deliver significantly lower value, means it is vital that workers are allocated to default products that are in their best long-term financial interests. In the absence of high quality default products, and an appropriate mechanism for allocating disengaged workers to them, millions of future retirees will experience lower retirement incomes than need be the case.

Getting defaults right is simultaneously about better outcomes for super fund members, better outcomes for government, and better outcomes for the Australian economy.

3.1 The current process for selecting default products in modern awards

The Commission has examined how millions of working Australians are allocated to default superannuation products before. In 2012 the Commission conducted a detailed inquiry into the role that the modern awards system played in allocating workers to default products. It concluded that 'Current default arrangements have provided stability, and investment returns of default funds have generally exceeded those of non-default funds.'[54]

However, the Commission concluded that reform of how the selection process operated was justified. One suggested reform option was to establish an expert panel within the Fair Work Commission for the purposes of helping the Fair Work Commission determine the best performing and most appropriate default products that should be listed in awards. Partly in response to this suggestion, in early 2013 the then government legislated to establish an expert panel which would be responsible for determining a list

[54] Productivity Commission (2012) Default Superannuation Funds in Modern Awards Inquiry Report, No. 60.

of default products from which the representatives of employees and employers would choose for each modern award.

This new selection process was due to commence operating on 1 January 2014. It has not done so because of vacant positions on the expert panel. In the absence of a properly constituted panel, the process for determining award listings has effectively been frozen.

Insofar as the Productivity Commission has previously acknowledged that the default selection process located within the Fair Work Commission has served default members well, it is reasonable to conclude that an improved version of that process would be very likely to continue to do so. No compelling evidence-based case for removing default product selection from the industrial relations system has been made.

The Fair Work Commission remains the most appropriate venue for deciding the listing of default products in modern awards for a number of reasons:

- *Superannuation is deferred wages and an industrial matter*. While minimum contributions are mandated by law, the rate of contributions, the funds to which they are allocated, and the industrial appropriateness of related products and services are routinely subject to collective bargaining and agreement. Employers and employees have a direct stake in these issues and it is therefore appropriate that decisions relating to default product choice are made via collective industrial means such as the Fair Work Commission.

  To transfer default selection to a body outside the realm of industrial relations would result in a process in which the priorities and voices of product providers are dominant, with the views of employees and employers accorded no formal status. It would be left to government and regulators to guard their interests, in a context where superannuation product providers have the loudest voice and are concerned primarily with agitating their commercial interests.

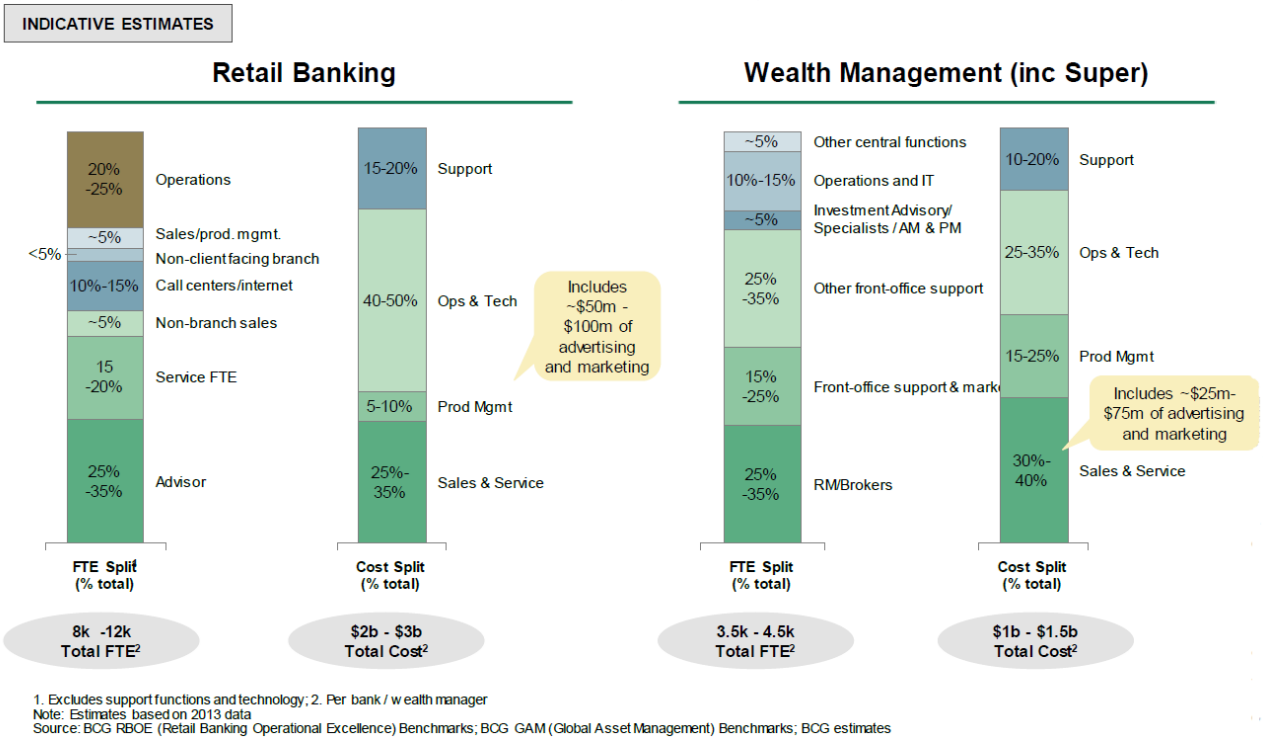
- *The distribution of superannuation via the workplace and subject to industrial determination has proven to be a highly efficient and cost-effective means of allocating disengaged workers to good performing default products*. Workplace distribution has helped industry funds to keep downward pressure on costs, with distribution determined by merit and a public service commitment to the interests of members above all else.

  By contrast, retail distribution is fuelled by significant spending on advertising, sales, customer interaction and administration. As a result, it is significantly more expensive. For a large retail wealth management business, the total costs are roughly in the range of 1 to 1.5 billion dollars per year, on average. By comparison, the total operational expenses for an average major not-for-profit super fund are only about 10 per cent of this, coming in at under $145 million per year.[55] While some of the difference could be attributable to a broader range of activities carried out by wealth managers, it is highly unlikely this explains all the difference.

[55] See: APRA Fund Level Reports 2012-2013 (operating expenses include expenses incurred which are not ordinarily directly associated with the generation of investment income (i.e. expenses that are not directly related to the investment portfolio of the superannuation entity, but more toward the administration of the superannuation entity))

Because these operating expenses are not decomposed, it is difficult to make direct comparisons or to specifically identify the underlying reasons for such significant differences between the indicative estimates of an average retail financial institution and an average major not-for-profit superannuation fund.

Figure 10 – Retail financial services costings (average major institution)



Source: Boston Consulting Group

- *The low cost and collaborative nature of default distribution via modern awards has the support of employers*. To many employers, including many small and medium sized businesses, the fulfilment of their superannuation obligations is as much a burden to be minimised, as an opportunity to support their employees. While many employers want good superannuation outcomes for their employers, they are often unable to spend the time and resources researching and taking advice on what products they should offer to employees. Many employers, like many employees, do not have the skills and knowledge to make appropriate decisions in this area. It is for these reasons that so many industry associations and employers support the existing default superannuation arrangements.

  Estimates of the aggregate cost to employers of changes to default fund arrangements that would require an employer to undertake the most basic of investigations to enable them to select a default fund for their employees outside of the guidance provided by a modern award are excess of $160 million per year.[56] In its inquiry into default funds in modern awards in 2012, the Commission also concluded that shifting the onus for selection of default super products directly to employers would involve unacceptable compliance costs for employers in determining the suitability of funds for their employees.[57]

  The workplace distribution of defaults by industrial means helps to minimise the costs that employers face when complying with their superannuation obligations and so has widespread employer support.[58]

[56] ISA, *Submission to Governance Discussion Paper*, December 2014

[57] Productivity Commission, *Review of Selection of Default Funds in Modern Awards* p 190 and box 8.1 p 171

[58] See the submissions to the Commission's 2012 inquiry by, among others, the Australian Hotels Association and the Australian Industry Group: http://www.pc.gov.au/inquiries/completed/default-super/submissions

3.2 Workplace defaults and the Australian economy

Default product distribution by collective industrial means, in which the Fair Work Commission plays a central role, has delivered benefits in addition to minimising marketing and choice-related costs.

Building Australia's capital base

Distribution based on merit, industrial relevance and a commitment to public service has helped to support a default system that is stable and growing in scale. This stability and scale has been used by industry funds to further the interests of fund members – and the broader Australian economy.

Relatively more predictable cash flows enable funds to engage in optimal strategic asset allocations and long-term investments – particularly in unlisted assets such as infrastructure. But only industry super funds and other not-for-profit funds deploy default flows into illiquid assets. This is apparent from Table 7, below. 17 per cent of default funds in modern awards are retail funds, but they have substantially underperformed.

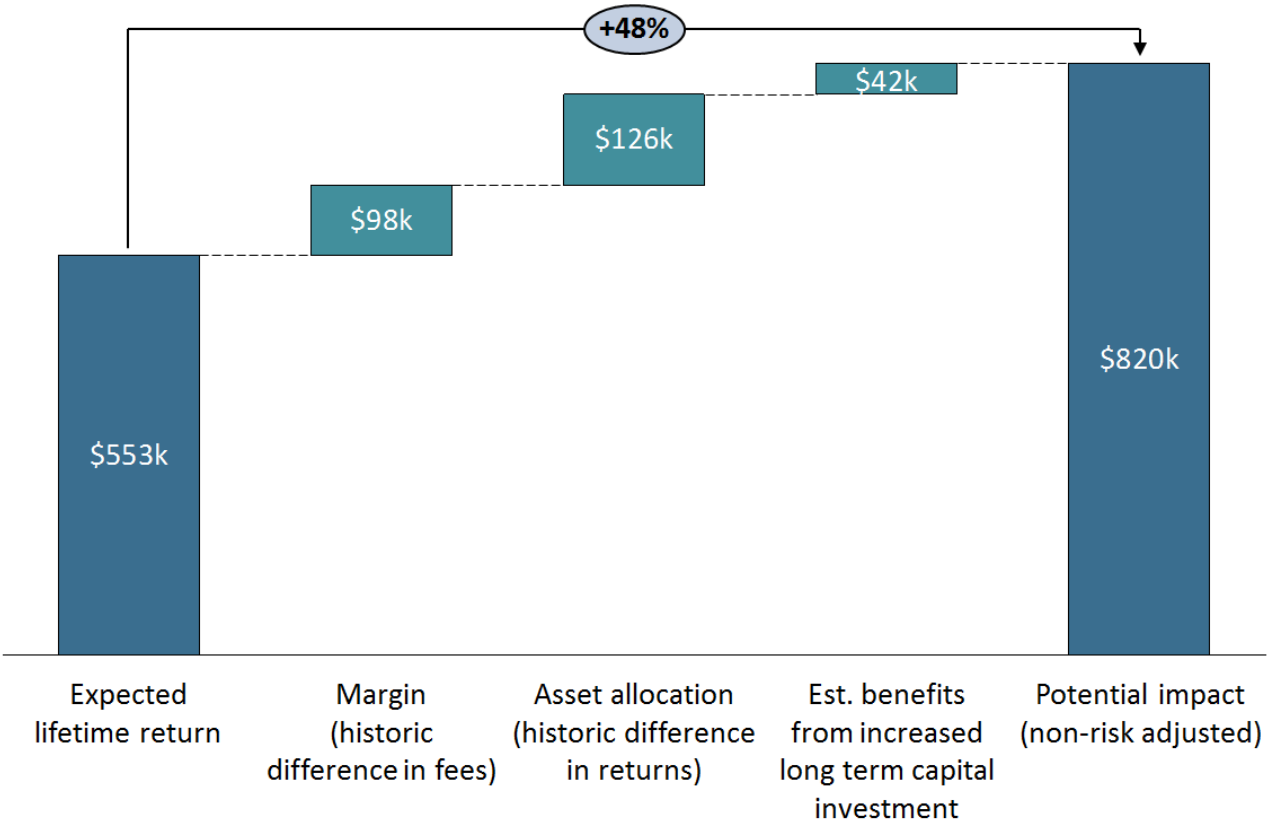
Table 7 - Average net returns by sector for products listed in Awards

	1yr	3yr	5yr	7yr	10yr
All	9.03	8.36	10.38	8.08	5.86
Industry	9.28	8.56	10.51	8.24	6.00
Retail	4.94	6.82	9.42	6.55	3.97

Source: ISA analysis of SuperRatings option-level data for 46 funds listed in awards for which data are available (weighted averages)
Note: Performance is for the specified years through September 2016

The superior risk-adjusted returns achieved by industry funds are driven partly by the asset allocations enabled by the stable cash-flows that accrue via the industrial default system. Industry fund asset allocation explains about one-half of the 50 per cent difference in retirement savings over a 40 year period. This is illustrated by Figure 11 below.

Figure 11 – Improved outcomes attributable to workplace super fund model



Source: APRA Superannuation Fund-level Profiles and Financial Performance, June 2013 (issued 8 January 2014), Boston Consulting Group analysis, ISA Analysis

Note: Example for an individual member aged 25 in 2010, 40 year contribution period, starting annual wage of $50,000, wages growth of 1.8%, portfolio return of 5%

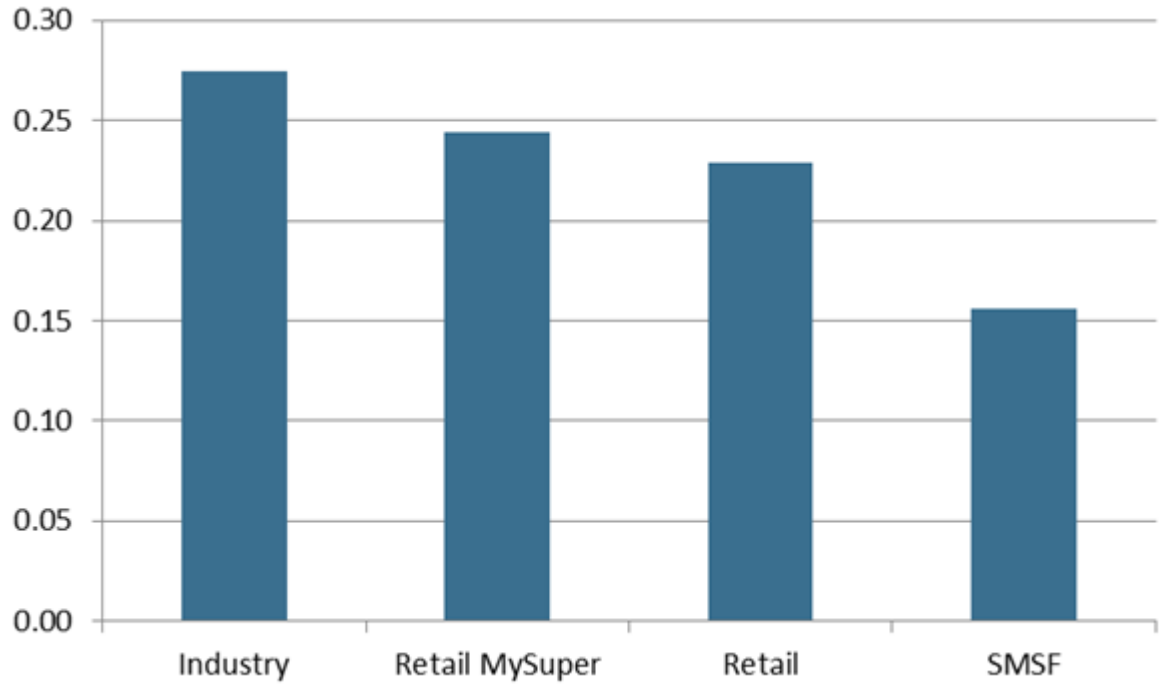
Research by APRA has found greater exposure to alternative assets (predominantly illiquid assets such as infrastructure) has contributed to increased risk adjusted investment returns for not-for-profit funds. APRA tested the investment performance of funds over the period 2004 to 2010 to determine if illiquid assets made a difference to fund performance and member returns.

The study[59] found that among 139 retail and not-for-profit funds, not-for-profit funds achieved an average net risk-adjusted investment outperformance of 144 basis points per annum, of which around one quarter (35 bps) could be attributed to a higher share of illiquid assets.

Greater levels of capital formation are needed to lift the economy, and a pipeline of new infrastructure investment would help to fill the growth void left by declining resource investment and deliver the productivity gains required to sustain improvements to living standards in the face of an ageing population. The not-for-profit and public interest orientation of industry funds, supported by our industrial default system, is helping to generate that capital – to the simultaneous benefit of members and the broader Australian economy. This is made clear by Figure 12 below.

[59] Cummings and Ellis, *Risk and Return of Illiquid Investment,* APRA Working Paper, 2011

Figure 12 – Capital formation per dollar contributed, 2012



Source: ATO, APRA, and ISA proprietary dataset; ISA calculations

Economies of scale to members

The undivided loyalty to members of industry funds means that as efficiencies such as economies of scale are achieved, these are passed on to beneficiaries.

Figure 13 below displays average rates of return for the ten financial years from 2004 to 2013 for superannuation funds grouped by profit orientation and size in assets.[60] Average performance improves with scale for not-for-profit funds but does not for retail funds. Average outperformance by not-for-profit funds increases from 1.1 per cent among smaller funds to 2.8 per cent for the largest funds (with assets over $25 billion).

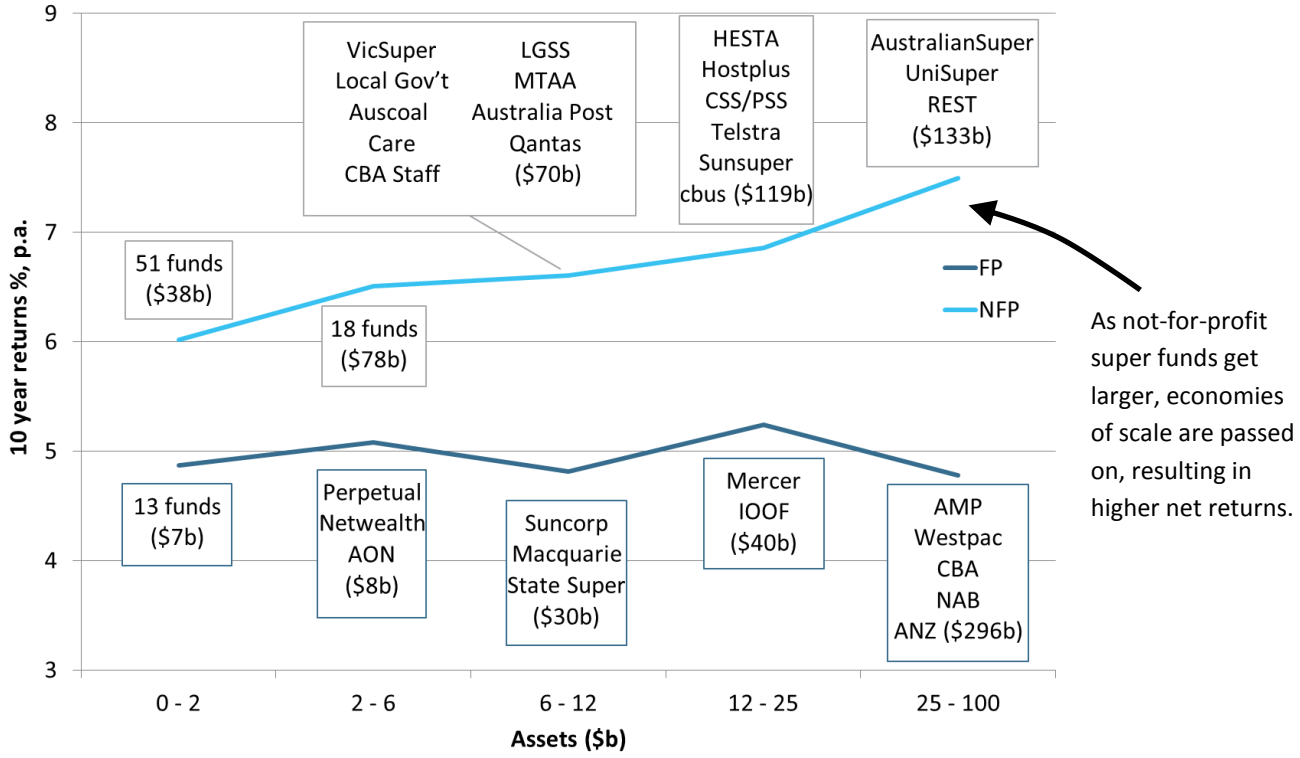
Economies of scale are presumably available to retail funds, but do not appear to be passed on to members. Recent research by APRA suggests that it is the latter.[61] In particular, retail funds do exhibit economies of scale, at least in relation to administration costs. Evidently, "the structure of retail funds… is less conducive to capturing the benefits of scale" for their members.[62]

[60] Funds are grouped as fund families, with asset-weighted average returns calculated for all retail funds within the same conglomerate.

[61] Cummings, James Richard, *Effect of fund size on the performance of Australian superannuation funds*, APRA Working Paper, March 2012

[62] Id.

Figure 13 – Fund level rates of return, averages, by profit orientation and size 2004-2013



Source: APRA (2013) Fund level performance data and profiles, ISA analysis

Scale economies also accrue to industry fund members in the context of lower investment management costs. APRA research has found that large not-for-profit funds are able to use greater bargaining power to get more attractive prices for investment management.[63] To explain the lack of such economies on the retail fund side, other APRA research found that retail funds on average pay substantially above market rate to service providers *if they are related parties*.[64] The funds management of large retail funds is generally provided by related parties.

APRA research has found that across a range of outsourced services, retail funds paid 81 bps more than market rates (133 bps instead of 52 bps) to related parties compared to non-related party service providers.[65]

Of particular note was the differential on administration costs. Payments to non-related party providers were $64.39 per member per year for a median cost fund, compared to $358.17 per member per year to related party providers. This represents a more than five-fold mark-up of cost.

[63] Id.

[64] Liu, Kevin; Arnold, Bruce; *Australian superannuation outsourcing: fees, related parties and concentrated markets*, APRA Working Paper, November 2010

[65] Id.

3.3 Expanding the default fund safety net to increase superannuation efficiency, net returns and capital formation

The current default system has a proven record of serving most members well in terms of net returns and helping to renew and expand Australia's capital base. In light of this record, the priority of policy makers must be to build on its success – not stumble into using a new and unproven default model because the commercial opponents of industry funds are agitating for easier access to the retirement savings of millions of disengaged workers.

While the workplace distribution of defaults has demonstrably worked well, overall system efficiency could be improved if the system was enhanced and expanded, such as through the following measures:

Excluding conflicts of interest

- Retail funds named as default funds have underperformed on average. For-profit funds named as default funds will include a margin in their fees.

  The most straightforward solution would be to exclude for-profit providers, as occurs in other jurisdictions.[66] Alternatively, explicit conditions could be added to for-profit applications to require for-profit funds to prioritise the interests of members over parent company shareholders. One option could be an "earn out" clause, pursuant to which profits could be paid to trustee shareholders only after a level of outperformance by the fund was obtained. In this way, profits would have been "earned" through outperformance; and shareholders and members would share value.

- A bank or related entity should not be permitted to provide default super fund services to employers where the bank is the main banking provider to the employer.

Reduce movement from the default system into underperforming models

Uplifting the efficiency of the superannuation system as whole requires expanding the coverage of the safety net as much as possible. In this way, more of the superannuation system would be within the model that has routinely outperformed all others.

In addition to strong default settings, it is important to include mechanisms to prevent movement from the safety net that reduces the efficiency of the system and/or outcomes to members.

Historically, much of the research about underperforming sectors focused on APRA-regulated retail funds. In recent years, as the level of transparency about self-managed super funds has increased, the underperformance of this sector has become clear. Self-managed super funds have average performance that is even lower than APRA-regulated retail funds.

Mechanisms that should be considered include (i) strong consumer protections around financial advice/product sales, including an objective test to ensure that the alternative to the safety net is in the best interests of the member, and (ii) eligibility conditions for members to exit the safety net that safeguard the public interest in their superannuation, including tax concessions. Regardless of any such conditions, members should always be free to choose another fund that has received approval from the default fund selection process, as this would not result in leakage.

[66] Such as in Sweden.

4. Responses to Specific Questions

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?

The Issues Paper's approach indicates that the Inquiry, in this early stage, privileges abstract theory over empiricism. Consistent with this, the Inquiry's criteria are incomplete. The most important factor to consider in evaluating any alternative model is the empirical outcomes that the model has actually achieved. Has it ever worked anywhere? If so, why? Otherwise, the Inquiry is at risk of recommending approaches based on abstract economic theory of a particular ideological school, similar to what happened in Chile.

The purpose of the Inquiry is to provide useful alternative models for default allocation, the implementation of which would be in the public interest.

What regulatory impediments to optimal competition might be relevant?

It is curious that the Inquiry has asked a question about the barriers to usage of certain means – competition – that have never delivered the best outcomes. Competition is just a means, not an end. There are no world class funded pension systems based on competition. And "optimal competition" is a fictional notion.

The regulatory barriers to optimal competition would include the multitude of differences between (i) theoretical assumptions for markets that produce welfare maximising equilibrium and (ii) the real world. These include demand-side capacity to receive information, time and capability to review and assess that information, and make optimal decisions under conditions of uncertainty. If one does not assume perfect information, and puts a cost against obtaining and evaluating information in an Arrow-Debreau style "complete market," the cost is infinitely expensive. The barriers also include supply-side factors, such as the value and culture of certain providers, as well as their incentives.

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

In explaining this question, the Issues Paper says "At a minimum, the models will need to include a competitive process and be 'workable'."

It is not appropriate for the Inquiry to insist that a model includes a "competitive process" because, as the Commission has elsewhere acknowledged, competition is only a means to an end.

An Inquiry that required the default selection model to be a competitive process would place form over substance.

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

As outlined above, the models used in the best performing pension systems share many features in common:

- The 2nd pillar default providers are private, industry or multi-industry plans.
- Products are distributed through the workplace.
- The default product is determined through either industry-wide or company-level collective agreements between unions and employers.

These systems already share many features with the best part of the superannuation system in Australia, namely the not-for-profit funds governed jointly by directors appointed by employers and unions.

One of the main lessons from these other systems is that the longstanding efforts by some to remove the connection between superannuation and the industrial relations system is misguided. Instead, the existing default system should be strengthened, its coverage extended, and protections placed on consumers who are peddled products in an effort to get the consumer to exit the default.

The system settings in the Netherlands and Denmark are cross-applicable to Australia. The existing default system in this country already has an industrial nexus. There already are industry funds, multi-industry funds, and corporate funds.

The benefit design in Netherland and Denmark differs from Australia, but this Inquiry is about distribution, not benefit design. In addition, the benefit design in Australia is in flux, and will come to resemble those countries far more as retirement income becomes the focus.

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

All employees should be covered. As in world class systems, the self-employed should be covered. There is a universal need for an efficient, funded, reliable retirement income that lasts for life – and self-employed workers are no different.

Should there be any flow-on effects for existing default members from any new default allocation model?

No comment.

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

The Fair Work Commission process that exists under current legislation should proceed. All accumulation products under this approach are required to be MySuper products.

In principle, however, MySuper is not necessary if a well-designed allocation process is in place.

A well-designed selection process is sufficient to ensure default members are allocated to high quality providers and products. Although MySuper does require standardised disclosures, existing disclosure requirements are not necessarily comparable or useful, particularly in relation to fees and costs including indirect costs. MySuper also constrains innovation because it requires products to be accumulation-only, among other things.

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?

Please see comments regarding insurance in Section 1.13.

What other considerations are relevant to specifying a competitive process?

Please see Section 2.

Culture, values, and profit orientation are demonstrably critical to whether a default fund will perform well for members. Involvement of industrial parties is relatedly important.

Also important are resilience against finance sector regulatory capture; practicality; and protections against loss-leading behaviour.

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?

Allocation by industry segment has been effective.

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

This question is difficult to answer without greater information about the default process involved. If employers and employees are not involved in the selection process, then they should be involved in selecting among the multiple default products.

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

The Inquiry's categories are very broad, and could potentially accommodate the models in Denmark and Netherlands, however we would suggest a fourth category to accommodate them: the "industrial 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? 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?

It is difficult to see how an administrative filter would be effective as envisioned by the Inquiry. It appears that the Inquiry conceives of a filter as requiring a specified minimum benchmark for certain factors. Insofar as the most important factor in ensuring a default fund is appropriate is net returns, and net returns can be volatile, and even negative, a static filter would not be appropriate.

The existing Fair Work Commission process is sometimes referred to as a filter, because it eliminates a substantial number of below-par offerings, resulting in a "filtered" population from which employers and employees can choose with reasonable confidence. This kind of a filter requires factors for evaluation by the decision-making body, but minimum quantitative features would not be appropriate.

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?

As is often the case, this question is difficult to answer because it depends on the details of the process.

A weak filter that covers the entire system would be of little utility. A strong filter pursuant to which few funds are eligible, and that covers the entire system could result in no appropriate options or an insufficient number of options for certain segments of the population.

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?

No comment.

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

No comment.

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

No substantive comment – responses depend on the details of the model. For example, a tender for a single fund that is held infrequently would ultimately destroy competition because of a lack of possible participants. A tender that is based on fees would see providers adopt low cost, but potentially low quality, strategies (to retain margins).

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? 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? 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?

No substantive comment – responses would require application of generalities and speculation. Effectiveness will depend on the details of the model.

Regarding the view expressed in the Issues Paper that "market models are generally more efficient than administrative allocation models, even in the presence of market imperfections," it is not clear this strong claim is supported by the literature. It matters greatly what is being allocated. The Inquiry should be well aware that many of the assumptions under auction theory are unrealistic. Although the press release cited by the Issues Paper in support of the position referred to papers in which the private valuations of bidders are independent, this is never true in the real world. The literature has sought to move beyond this limitation. However, post-auction profit opportunities, and costs, make incentive compatibility intractable. Predictions about the efficiency of auctions, e.g., second-price auctions, rely on theoretical predictions of how the bid-taker (government) will behave, and the bidder must have certainty that this will happen.

There are challenges to auction theory, and more importantly the practical utility of it, notwithstanding its admitted elegance.

There are instances in which auctions can be efficient and an appropriate tool. They are used in securities markets (generally Dutch auctions), in the sale of treasury bills, and the allocation of private rights to usage of electromagnetic spectrum bands. These applications do not resemble superannuation in material respects.

Most importantly, the Inquiry has evidence ready-to-hand which compares pension systems that use an auction model with pension systems that use an industrial model, and the industrial model is demonstrably superior.

What are the advantages and disadvantages of an active choice model? How can these costs and benefits be assessed and measured? What safeguard mechanisms might need to be put in place to deal with some of the potential pitfalls of an active choice model? 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? 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?

The Issues Paper's "active choice" approach would appear to be difficult to implement seriously.

It would require millions of people who are not interested or equipped to make decisions about superannuation to do so. (In this connection, please consider Figure 3, Figure 7, Figure 8, Footnote 9, Footnote 18, Footnote 20, and the text accompanying each.)

Ensuring that these people make an *informed choice* will require the information furnished to be of high quality and comparable; and will require each person to read multiple prospectuses, and receive training in how to digest the information beforehand. Existing disclosure requirements are not comparable.[67] Reviewing multiple prospectuses will take a lot of time – who will pay for it? The training should be unbiased – where would it be sourced from? Existing evidence about how even informed consumers behave in connection with retirement income decisions suggests poor decisions will result. These costs, when aggregated, would be substantial.

In assessing whether these costs could be justified, the Inquiry should keep in mind that financial literacy and information are not sufficient to facilitate good outcomes. Cognitive limits and biases prevail. Dispassionate prudential management by professionals outperforms.

It seems questionable that government should force savings under the Superannuation Guarantee, and then force the conscripted saver to make a complex choice.

Combining "active choice" with some kind of quality filter is only superficially attractive. If the filter is sufficiently tight (i.e., applies very high quality standards), what is the value of active choice over and above the filter?[68] If the filter is too loose, the problems with unfettered active choice reappear.

To assess the costs of forced choice upon consumers it is necessary for the following elements to be measured, which will vary depending on how the Inquiry constructs an "active choice" approach:

- Time cost – for every single person – of obtaining and reading disclosure documents for all relevant options
- The cost of assisting consumers to digest the information sensibly
- The cost on every single consumer to monitor their existing product, review prior decisions and evaluate other options on a regular basis
- The costs on providers and regulators of facilitating this monitoring and switching behaviour, as well as the effect on asset allocation to accommodate liquidity risk.
- The cost to members of poor choices.

[67] See footnote 18.

[68] It could be asserted that individual tailoring and accommodation of individual preferences could be better enabled. However, the Inquiry is examining default settings for 2nd Pillar products, not 3rd Pillar products. The 2nd Pillar is the public policy instrument for satisfying the universal needs of retirees for income streams. Substantially all retirees need a reasonably reliable income. The 3rd Pillar is to accommodate individual preferences for higher incomes, or more contingent risks.

Public policy should respect members as they are

Some policy makers seem driven to change members, and encourage them to interact with superannuation as they might a financial product. But superannuation is not a financial product – it is an instrument of social policy.

It is entirely appropriate for many members to believe that a government that has compelled savings should ensure those savings are managed efficiently and effectively, and converted into reliable retirement income streams.

Evidence suggests behavioural finance has identified a number of characteristics of consumer behaviour which disable consumers from making rational choices. These characteristics are not limited to literacy and engagement, but point to deeper cognitive limitations that compromise consumer actions and therefore their capacity to make meaningful decisions about their financial future.

Some of the limitations include:

- *Cognitive constraints* - Most people, including the minority of people who are financially literate, have difficulty understanding probability, and make irrational decisions about risk.[69] Similarly, while most people substantially underestimate average life expectancy, even those with high financially literacy struggle to understand mortality risk and survival probability.
- *Choice overload* - When the range of choices becomes too large for people to make investment decisions using a simplistic heuristic, they are less likely to make a decision.[70]
- *The endowment effect and loss aversion* - Whereby individuals prefer to retain what they have. This is generally interpreted as the result of the initial holding changing their preferences, or that there is a greater discomfort attributable to giving up something already possessed.[71]
- *Inertia* - Research has demonstrated that many people faced with choice tend to defer or avoid making a decision.[72] For example, one Australian study found that one in three Australians often put off financial decisions until later.[73]
- *Bounded self-control* - Many people understand the importance of saving for retirement, and decide to do so, but do not have the self-control to execute their intentions.[74]
- *Hyperbolic discounting* - Many people place a lower value on future benefits, and overvalue the present.[75] In the superannuation context, this leads to people placing a low priority on saving for retirement.

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[69] D Kahneman Maps for Bounded Rationality: Psychology for Behavioural Economics The American Economic Review (2003) 93 1449.

[70] For example, one study showed that as the number of investment options in an optional s 401k plan increased, employee participation decreased : S Iyengar et al, How much choice is too much? Contributions to 401k retirement plans 9-10 (Pension Research Council, Working Pap er No 2003-10, 2003)

[71] See, e.g., Ericson and Fuster, The Endowment Effect, NBER 2013

[72] See for example B Madrian and D Shea, The Power of suggestion: Inertia in 401(k) participation and savings behaviour (2001) 116 Quarterly Journal of Economics 1149.

[73] J Fear, Choice Overload: Australians Coping with Financial Decisions, The Australia Institute, Discussion Paper 99, 2008.

[74] R Thaler and H Shefrin, An economic theory of self control (1981) 89 Journal of Political Economy 392.

[75] O Mitchell and S Utkus, Lessons from Behavioural Finance for Retirement Plan Design Financial Institutions Center 03-34 at 5-6.

- *Framing effects* - People are easily influenced by decision framing – they make a choice based on how the options presented to them relate to one another, how they are explained and what information is provided at the same time. Research into the impact of investment menu design on choice of investment option has found that menu design is a more powerful influence on decision-making than the risk-return characteristics of the options themselves.[76]
- *Prospect theory* - People tend to be risk-averse for a known gain, but can become risk-seeking in an effort to avoid a certain loss.[77] In the superannuation context, this has numerous effects including overconfidence about the likelihood of investment gains and unwillingness to realise investment losses.
- *Naïve heuristics* - People use mental shortcuts which lead to poor decision making. For example:
  - *The 1/n heuristic* - the tendency to allocate equally across all available options.
  - *The representative heuristic* - the tendency to see patterns in small series of randomly drawn numbers, in an attempt to impose structure on information that is otherwise incomprehensible. This leads people to rely on past performance.
  - *The availability heuristic* - the tendency to rely on readily available information. This also leads to irrational reliance on past performance.
  - *The default heuristic* - the tendency to accept the default option, especially if implementing this option does not require any action. Recent Australian research about how people chose a retirement income stream found that more than 30% of choices were based on the default or the 1/n heuristics[78].

Financial literacy cannot address all challenges

It is well established that financial literacy levels in Australia are low. Research also demonstrates that efforts to increase financial literacy has very little impact. For example, one study considered the before-and-after test results from a group of employees who received financial literacy education. The net result of the educational program was a one point increase in the employees' test scores, from 54 to 55. Purely random answers would score 50 because the test consisted of true/false responses.[79]

This has led one Australian regulator and academic to warn:

> There are few certainties in life, but one of them is: "Investment education has zero chance (not 10 percent or even 1 percent chance) of making the average person an expert investor."[80]

Perversely, financial literacy education may actually do more harm than good, increasing confidence without improving ability, leading to worse decisions and poorer outcomes for many people.[81]

In addition, the behavioural economics literature demonstrates that even employees with high levels of financial literacy are affected by behavioural biases and make irrational decisions. For example, Dr Harry Markowitz, speaking about his own retirement savings, said: 'I should have computed the historic

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[76] Mitchell and Utkus at 15.

[77] D Kahneman and A Tversky, Prospect Theory: An Analysis of Decision Under Risk (1979) 47 Econometrica 263-91.

[78] H Bateman et al, Default and 1/n heuristics in annuity choice (2013).

[79] R Thaler and C Sunstein, Nudge, Improving decisions about health, wealth and happiness (2008) at 112.

[80] W Sy, Redesigning choice and competition in Australian superannuation (2011) 4 Rotman International Journal of Pension Management 52, 56 (quoting Don Ezra).

[81] Id.

covariances of the asset classes and drawn an efficiency frontier. Instead, I split my contributions fifty-fifty between bonds and equities.'[82]

Dr Markowitz was applying the 1/n heuristic described above.

Observable member behaviour

Over a decade after the introduction of Choice of Fund, switching between funds is limited. The percentage of members switching funds in any given year has consistently hovered around 3 per cent.[83] It is important to note that switching funds is often driven by (1) a change of job rather than exercising Choice of Fund, which means that switching is not equivalent to engagement, or (2) sales efforts of providers, which is a form of engagement, but typically associated with worse outcomes.

The behavioural economics literature demonstrates that many employees have a general lack of interest in managing their superannuation. Experiments have shown that:

Employees are willing to make only a minimal time commitment to retirement plan managements. For example, participants in a study conducted by Professors Bernartzi and Thaler spent on average less than an hour making asset allocation decisions, and few of those participants reviewed any material other than what funds provided.[84]

Employees are reluctant to revisit their initial decisions, even if their circumstances or financial market conditions change substantially. For example, one study found that over the lifetime of a group of university employees, the median number of asset allocation changes was zero.[85]

[82] R Thaler and C Sunstein, Nudge, Improving decisions about health, wealth and happiness (2008) at 123.

[83] In January 2016, Roy Morgan found that in the three years to November 2015, the average amount of superannuation switched each year was $35 billion, or 3.2 percent of products Roy Morgan, Over $35 billion in superannuation switched but nearly one third of switchers didn't get any advice, 6 January 2016, http://www.roymorgan.com/findings/6617-over-35-billion-in-super-switched-but-nearly-one- - -get-advice-201601052255.

[84] S Bernatzi and R Thaler, Risk aversion or myopia? Choices in repeated gambles and retirement investments 45 MGMT SCI 364, 375 (1999).

[85] R Thaler and S Bernazi, Save More Tomorrow Using Behavioural Economics to Increase Employee Saving 112 J Pol Econ 164, 168 (2004).

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