# 3 Conceptual framework

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| Key points |
| * In a well-functioning market for superannuation, individuals would be well informed and have the expertise and motivation to choose a fund that meets their best interests. * In reality, many do not have the interest or ability to make decisions that are in their best interests and do not actively choose a superannuation fund. Although the proportion of individuals who actively make a choice is expected to increase over time, a default superannuation system will be required for the foreseeable future. * A default system can improve outcomes for individuals. However, there are some potential impediments to maximising outcomes through the use of a default system that need to be addressed. * Where a third party is making decisions for an individual (a principal–agent relationship), the interests of these parties will not necessarily be totally aligned and the decisions made by the third party might not always be in the best interests of the individual. * A lack of demand-side competition can reduce the incentives for funds to compete on price and performance to deliver good outcomes for members. * Any one default product cannot be optimal for all members as it is a homogeneous product, but people have heterogeneous attributes. This means that the optimal choice will differ between individuals. * Regulatory barriers can restrict contestability between superannuation funds. * With a focus on default funds listed in modern awards, this inquiry examines what impediments there are to meeting the best interests of employees who derive their default superannuation product in accordance with modern awards, the extent to which the Stronger Super reforms are expected to address these impediments, and whether there is a net benefit to introducing criteria beyond those required of funds to be authorised to offer a MySuper product. * Good outcomes, particularly for individuals, depend not only on the criteria by which default funds are selected, but also on the process by which those criteria are applied. Therefore, the net benefits of reforming the process for listing default superannuation funds in modern awards will also be examined. |
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In 1992, the Australian Government made superannuation compulsory. The Government’s decision largely stemmed from:

* the fiscal imperative to reduce reliance on the aged pension
* the desire to increase national savings and economic growth, and achieve better retirement outcomes for the community (Kingston 2004).

In a well-functioning superannuation market, individuals would be well informed and have the expertise and motivation to choose a fund that meets their best interests. However, as explained in a wide body of literature, many individuals lack the interest or ability to make retirement savings decisions that are in their best interests (box 3.1).

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| Box 3.1 Difficulties faced in making retirement savings decisions |
| Individuals might encounter difficulty making retirement savings decisions in their own best interests for a number of reasons.   * Lack of financial literacy, which limits people’s ability to make informed financial choices (Australian Government 2010a). * Complexity of investment decisions and difficulty matching risk preferences with the right products (Brown, Farrell and Weisbenner 2011; Ingles and Fear 2009). * High search costs, in terms of time taken to research and understand what is often a large number of products (Impavido, Lasagabaster and García-Huitrón 2010). * The ‘endowment effect’, where people value money that is lost more highly than money gained, causing them to be unduly conservative in their investment decisions (Ingles and Fear 2009; ISN 2010). * Lack of price awareness, as compulsory contributions, fees and other costs do not come directly out of members’ pockets (Australian Government 2010a). * Information asymmetries between superannuation providers and individuals (Brown, Farrell and Weisbenner 2011). * A long lag between the purchasing decision and the time when the benefits can be accessed (Fear and Pace 2008). * An associated tendency toward procrastination and inertia in making retirement savings decisions (Gallery, Gallery and Brown 2004). * Mental rules or short cuts (heuristics) that people use when they have no clear preference, or where the cost of acquiring information is too high, which can lead to persistent biases in decision making (Fear and Pace 2008). * Framing effects, where people choose based on how the available options relate to one another, how they are explained and what other information is provided at the same time, rather than which option is in their best interests (Fear and Pace 2008). |
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One policy option for addressing the tendency for individuals to make sub-optimal retirement savings decisions is to provide information and implement financial literacy programs to assist them (Bernartzi and Thaler 2007; Brown, Farrell and Weisbenner 2011).

Another option is to introduce a default superannuation system, whereby a third party effectively makes a choice of superannuation fund on behalf of the individual. Under a default superannuation system, an individual can be given the option of choosing for themselves, as has been the case in Australia since Choice of Fund legislation was passed in 2005 (chapter 2), or individual choice can be restricted.

While there is a substantial body of evidence that a default system improves outcomes (for example, Thaler and Sunstein 2009; Bashears et al. 2006), its success in doing so is contingent on the appropriate design and application of the system. Otherwise, unintended and sub-optimal outcomes can readily materialise (Gallery, Gallery and Brown 2004).

## 3.1 Potential impediments to meeting the best interests of members

There are several potential impediments to meeting the best interests of members under a default superannuation system, some of which are unique to the Australian system. A well-designed default superannuation system needs to take these impediments into account and minimise the effects that they have on outcomes.

### Principal–agent relationships and information gaps

Principal–agent relationships are inherent in any default superannuation system. A principal–agent relationship is one where an individual engages (or relies on) a third party to make decisions and take action on their behalf (Drew and Stanford 2003). Having an agent might be optimal if that agent acts in the best interests of an individual lacking the expertise to make decisions in their own best interests. However, issues can arise when the agent does not face adequate incentives to act in the best interests of the individual, and that individual does not have the information or means to monitor the actions of their agent.

In Australia’s default superannuation system, there are several principal–agent relationships that can be cause for concern, and any negative effects from these need to be addressed in the design of the system.

#### Employees and employers

In the Australian default superannuation system, employers choose a default fund (either from a list contained in the relevant award, in negotiation with employees such as through an enterprise agreement, or unilaterally) for employees who do not choose themselves.[[1]](#footnote-1) Where an employer is free to choose any default fund for employees (that is, where an award does not require them to make a contribution to a particular fund, or an enterprise agreement does not specify a default fund and does not refer to the terms of the award for superannuation purposes), or where an award lists many funds, there are reasons why employers might not have the incentive to make a decision that is in the best interests of their employees.

Employers:

* receive none of the direct benefits of a fund’s high performance, and therefore might have little incentive to invest time and effort into making choices that are in the best interests of their employees
* could choose a fund solely on the basis that it has the least onerous administrative requirements
* might face high search costs when trying to make an optimal choice, especially when choosing from a large pool of potential funds, and especially when they themselves lack information and expertise
* could choose a fund that has additional benefits specific to them, such as access to financial products for their organisation
* might be driven by concerns about any legal repercussions of choices they make, rather than the best interests of their employees.

#### Employees and industrial parties

In Australia, industrial parties have played a central role in determining which superannuation funds are listed in awards (chapter 2). In choosing a default fund, they might bring their own incentives and biases to that task. For example, there is potential for conflict of interest given that the industrial parties have an ownership stake in the relevant industry fund (Drew and Stanford 2003). There might also be asymmetric interests at the workplace level where trade unions might have an interest in allocating contributions to an industry fund, whereas individual employers might be more equivocal about the choice of default fund.

#### Fund members and fund trustees

Trustees of funds manage and invest the contributions of members. In doing so, trustees might not always act in the best interests of their members unless explicitly required to do so (chapter 5). According to the Australian Government (2010b, p. 5), trustees are ‘not always focussed on acting for the benefit of members and maximising members’ retirement incomes in an efficient and cost‐effective way’. (To deal with these concerns, the Government has proceeded with a number of governance-related reforms — see chapter 5.)

If funds are not disclosing information in an open, transparent and easy to understand manner, members may find it difficult to assess how well funds are performing on their behalf. Members may also have difficulty making this assessment if they do not have the expertise to do so.

#### Financial advisers and their clients

In the default system, employers or employees might use a financial adviser to help them choose the right fund. Due to the way that some advisers have been remunerated (based on commissions rather than fee-for-advice), they might be conflicted in the advice they give to their clients (Vidley 2004). These potential conflicts have been dealt with in the Future of Financial Advice legislation (chapters 5 and 6). Where independent advisory firms focus on running corporate tenders, conflicts are much less likely to exist.

#### The Australian Government and the private superannuation sector

Principal–agent relationships also exist at the aggregate level. The Australian Government has made superannuation savings mandatory, with a view to reducing reliance on the aged pension and improving retirement outcomes, and it uses the private (not-for-profit and for profit) sector as its agent to manage those savings. The superannuation sector overall is not necessarily driven by the same objectives as the Government.

### Lack of demand-side competitive pressure

While default superannuation systems can improve outcomes, they do not alter the underlying attitude of indifference by individuals towards making retirement savings decisions (ISN 2010). In fact, by providing a default system, indifference can grow, as some of those who may otherwise have chosen to engage might feel that a default chosen by a third party is a signal or endorsement of the best choice (Brown, Farrell and Weisbenner 2011).

The tendency for individuals not to make active choices means that, once placed in a fund, they tend to stay there. According to the Cooper Review (Australian Government 2010a), since the introduction of Choice of Fund legislation in Australia, switching rates between funds have declined from an initial rate of around 5 per cent in 2005 to 2 per cent in 2009 (and most switching takes place due to people changing jobs).

Given the growth in the self managed super fund sector (chapter 2), it might also be the case that active participants are increasingly choosing to manage their own retirement savings rather than choosing amongst existing funds.

A lack of active participation means that members will tend not to respond to price signals (that is, demand is price inelastic) and little demand-side pressure will be placed on funds both within and outside the default system to compete on price and performance (Fear and Pace 2008). According to the Australian Government (2010a):

In superannuation, competition in the market for super at the consumer level (ie between funds competing for the business of a new member) has so far been relatively weak. This is because superannuation is different … the model of member‐driven competition through ‘choice of fund’ (in the form of SG Act choice and consequent portability) has struggled to deliver a competitive market that reduces costs for members. (Australian Government 2010a, pp. 7–8)

Instead of being driven by individuals, demand-side competition could be driven by those making decisions on behalf of members, such as employers, financial advisers and industrial parties. However, for this mechanism to operate, these third parties need to have the incentive to actively participate on behalf of members and not be subject to inertia themselves. And, as discussed above, such incentives might not always be present, given the inherent nature of principal–agent relationships.

A lack of demand-side pressure can lead to:

* administrative inefficiencies within funds, including difficulties for employers dealing with funds
* price distortions
* non-price competition around marketing, distribution and product differentiation, which is costly and of little benefit to those members in default funds not making active decisions (Impavido, Lasagabaster and García-Huitrón 2010). (This is what occurred in Chile in the 1980s and 1990s — appendix B.)

### Moral hazard

Government involvement in the default system can raise the issue of moral hazard. If a major fund is performing poorly or has the potential to collapse, the government might feel obliged to take action to protect the interests of members of that fund, particularly if the fund is seen as ‘too big to fail’. This can encourage funds to engage in riskier behaviour than they would have otherwise, and distort the efficient operation of the market.

### Heterogeneity of member preferences

Any one default superannuation product is a homogeneous product in most aspects. However, people have heterogeneous attributes, such as risk preferences and demographic characteristics, which means that the optimal choice will differ between individuals (Carroll et al. 2009). This problem is compounded if the product is not adjusted to suit the changing nature of individuals’ preferences over time (Brown, Farrell and Weisbenner 2011). The more closely aligned the preferences of members within a default fund, the better the potential outcomes for those members.

### Regulatory impediments

Regulatory impediments can create barriers to entry for funds wishing to participate in the default system. For example, the process by which funds are listed in modern awards could be acting as a regulatory barrier to entry (chapter 7).

Barriers to entry impede contestability and provide scope for incumbent funds to underperform and/or drive up costs (Impavido, Lasagabaster and García-Huitrón 2010). This can exacerbate the problems caused by a lack of demand-side competition.

## 3.2 The Stronger Super reforms

The Cooper Review and the Government’s response through the Stronger Super reform package were aimed at addressing some of the impediments to meeting the best interests of members mentioned above. According to the Cooper Review:

The current superannuation system assumes that all members want to make choices about their superannuation and are interested in receiving a variety of superannuation‑related services. ‘Default’ members are not adequately protected and can find themselves paying for services that they do not need or request and, on some occasions that they do not receive. (Australian Government 2010b, p. 5)

The focus of the Cooper recommendations is on member outcomes. They are based on the idea that, as superannuation contributions are mandatory, members should not have to be ‘interested, financially literate, or investment experts to get the most out of their super … If members are not interested, then the system should still work to provide optimal outcomes for them’ (Australian Government 2010a, p. 1).

More specifically, MySuper is aimed at enabling:

… members, employers and market analysts to compare funds more easily based on a few key differences. It will also ensure members do not pay for any unnecessary ‘bells and whistles’ they do not need or use. (Shorten 2011b, p. 3)

MySuper will provide information in a manner that will allow easier comparison between products. In this sense, the MySuper regime is primarily about increased disclosure and equips individuals, to a degree, with information to make choices for themselves. Other factors might also contribute to an increasing trend in self-choice (box 3.2).

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| Box 3.2 Reasons why self-choice might increase over time |
| * MySuper will provide a filter for consumers, reducing the number of options from which a choice needs to be made (though the option of choosing from outside MySuper would remain). Consolidation will also reduce the number of funds to choose from (chapter 2). * The information available to make a choice will be more comparable because of the MySuper reforms. * The informal sources of information about superannuation have grown as the compulsory system matures. * Access to information about savings choices is easier and cheaper as the internet becomes increasingly easy to use and access. * There is a greater focus on financial literacy in schools and the community (ASIC 2011a), meaning that savers are likely to be more sophisticated in their knowledge than in the past. * There may be a greater understanding by upcoming generations that the capacity of government to provide for retirement incomes may be reduced, resulting in greater appreciation that individual savings choices matter. |
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However, there is still a question of whether individuals will have the interest or ability to use the information from MySuper to make quality decisions about their retirement savings. There is likely to be a long way to go before the vast majority of Australians are actively choosing a superannuation fund, and thus a robust default system is likely to be necessary for the foreseeable future.

There is also a question of whether employers will have the expertise to use the information from MySuper to make quality decisions on behalf of their employees without incurring excessive search costs.

## 3.3 Framework for assessing the case for further reform

This inquiry assesses whether there is an overall net benefit to introducing criteria beyond those required for the authorisation of a MySuper product, for a product to be listed in modern awards.

In doing so, the Commission focuses on whether the Stronger Super reforms are expected to do enough to address any impediments to meeting the best interests of employees who derive their default superannuation product in accordance with modern awards, or whether there is scope to improve outcomes by using additional criteria.

Chapters 4 to 6 assess the net benefits of introducing criteria over and above those that will apply under Stronger Super. These chapters cover:

* the current requirements for superannuation funds
* what additional requirements are contained in the Stronger Super reform package and what impediments to meeting the best interests of members they are seeking to address
* whether the Stronger Super reforms go far enough, or whether there are any remaining impediments to meeting the best interests of employees who derive their default superannuation product in accordance with modern awards
* whether there is a case for additional eligibility criteria, by weighing up the benefits (such as increasing members’ retirement savings) and costs (such as administrative, transaction, compliance and monitoring costs) of introducing any additional criteria
* if a case for additional criteria is established, what those criteria should be.

The overarching objective of the inquiry is to assess, and propose any necessary reforms to, the system such that it meets the best interests of employees who derive their default superannuation product in accordance with modern awards. However, the effects on other employees, employers, industrial parties, superannuation funds and the Government are also taken into account.

While the focus of this inquiry is on default funds listed in awards, the Commission also considers whether its findings and recommendations have any implications for awards that do not currently contain a list of funds.

Minimising the impediments to achieving the best interests of employees who derive their default superannuation product in accordance with modern awards, such as the potential principal–agent and contestability issues, might depend not only on the criteria that the default fund must meet, but also on the process by which those criteria are implemented and funds are selected. Therefore, in addition to looking at designing a set of criteria, the Commission examines in chapter 7 whether there is scope to enhance the best interests of employees who derive their default superannuation product in accordance with modern awards by reforming the process for listing funds in awards. A principles-based approach is used to assess the appropriateness of the current process and the potential reform options.

Chapter 8 assesses the options for implementing any additional criteria and reforming the process, while chapter 9 examines how the reforms can be implemented in a way that maximises the overall net benefits.

1. In some countries, this is not the case. For example, in Sweden, the Government operates and manages a single national default fund. In New Zealand, the Government selects a number of default funds, amongst which employers may then choose (appendix B). [↑](#footnote-ref-1)