Australian Government
Productivity Commission

Superannuation: Alternative Default Models

Productivity Commission Draft Report

Overview

March 2017

This is a draft report prepared for further public consultation and input. The Commission will finalise its report after these processes have taken place.

An appropriate reference for this publication is:

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The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).

Opportunity for further comment

You are invited to examine this draft report and comment on it by written submission to the Productivity Commission by **Friday 28 April 2017**. Further information on how to provide a submission is included on the inquiry website at www.pc.gov.au/inquiries/current/superannuation/make-submission

The final report will be prepared after further submissions have been received and public hearings have been held, and will be forwarded to the Australian Government by 17 August 2017.

Public hearing dates and venues

Location	Date	Venue
Melbourne	3 May 2017	Productivity Commission Level 12, 530 Collins Street
Sydney	8 May 2017	The Grace Hotel 77 York Street

Commissioners

For the purposes of this inquiry and draft report, in accordance with section 40 of the *Productivity Commission Act 1998* the powers of the Productivity Commission have been exercised by:

Peter Harris	Chair
Karen Chester	Deputy Chair

Contents

OVERVIEW

Key points

- Superannuation has evolved much since compulsory superannuation was first introduced a quarter of a century ago. Today's default arrangements evolved historically within the workplace relations system, and provide a safety net for employees that don't or cannot make a decision in a world of compulsion.
- So after 25 years, this Inquiry is a timely opportunity to look at potential ways to introduce more competition into a system that benefits from a large flow of mandated superannuation contributions, and much of that from disengaged members.
- Complementary policy action (including to extend genuine member choice to all employees) is needed to deliver the full potential benefits of member-driven competition under the models we identify and even under current default arrangements. The freedom to make choices is necessary to realise the benefits of competition.
- Two-thirds of members stick with their default fund. If the system is going to rely on defaults, it needs to guide members to products that at a minimum seek to maximise long-term net returns.
- In this draft report the Commission has developed four alternative models that are likely to outperform a baseline of 'no defaults' on member benefits and competition.
  - They try to address the core problem in superannuation — the sheer complexity of decision making coupled with compulsion — by increasing the availability and quality of information or nudging choice to a smaller set of high-quality products.
  - But these interventions come at a cost, and each model has different relative strengths and weaknesses.
- Members who do not exercise choice should be allocated to a default product only once. The current system's propensity to create multiple accounts is an egregious systemic failure. It warrants more than the incremental remediation to date.
  - This approach would result in a smaller pool of employees being defaulted each year, but it should be sufficient to generate competitive dynamics.
- There should be a government-run centralised online information service, with universal participation by employees and employers, to facilitate more efficient allocation of default members to products.
- A centralised clearing house (akin to New Zealand's), while a more ambitious undertaking, would have wider and more enduring member benefits.
- Member outcomes would also benefit from more transparent disclosure by funds regarding merger considerations, to hasten the exit of underperforming funds.
- Certain reforms indicated in this report will be examined further in the stage 3 review.

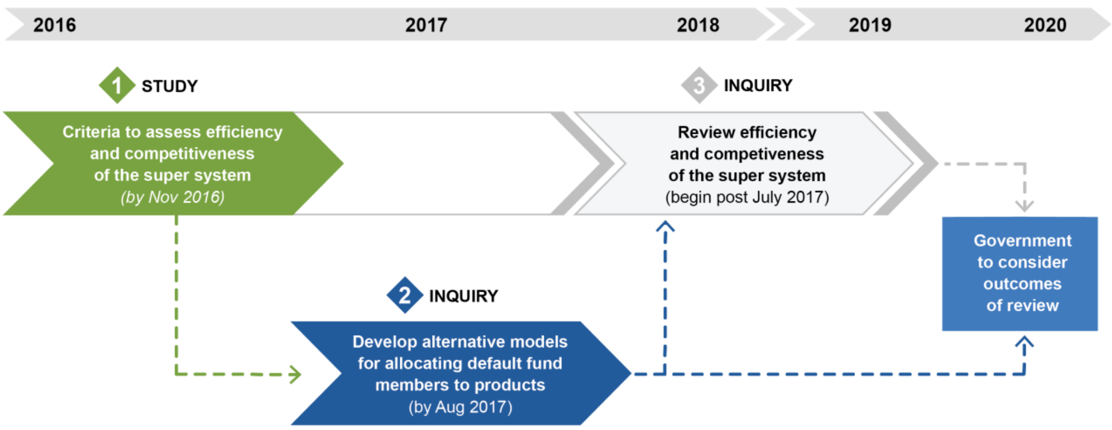
Overview

In Australia's superannuation system, most risks — in relation to the level of contributions, investment returns, fees and ultimately the benefit in retirement — lie with the individual. And yet the superannuation system hasn't always afforded or encouraged individual decision making. Some is well-intentioned paternalism, reflecting the compulsory and complex nature of superannuation, while other arrangements are merely a historical overhang. Both elements coexist in Australia's arrangements for allocating default superannuation members to products ('default arrangements').

In many ways default arrangements can be beneficial to members and are common around the world in retirement savings systems. But they can also stifle competition and innovation that would otherwise occur when consumers make active decisions, and discourage individuals learning about a sizeable asset held on their behalf. Striking the right balance between these benefits is imperative for a system that collectively compels large mandated savings and affords individual responsibility (and with it risk), and an economy where job mobility is the norm.

The Commission has been asked to develop alternative workable models for a formal competitive process to allocate default superannuation members to products. These new alternative models could be implemented by the Australian Government if deemed desirable following the Commission's future review of the efficiency and competitiveness of the superannuation system — to be undertaken sometime after 1 July 2017.

Figure 1 **Stage two in a three-stage superannuation review**



This Inquiry represents the second of three related pieces of work on superannuation to be undertaken by the Productivity Commission (figure 1). These stem from the Australian Government's response to the recommendations of the 2014 Financial System Inquiry (FSI). The FSI found that the superannuation system was not operationally efficient due to a lack of price-based competition in the superannuation default market.

Importantly, the Commission's task in this Inquiry (stage 2) is to develop *new competitive models* for future consideration by the Australian Government. The Commission is not tasked in this Inquiry to form a view on whether alternative models are better or worse than the current default arrangements, nor on the merits of the current default arrangements. This is core to the overall competitiveness and efficiency of the superannuation system and will therefore be examined as part of the stage 3 review of the competitiveness and efficiency of the superannuation system.

The role of competition in superannuation

Competition can promote better outcomes for consumers, such as lower prices, improved service quality and product innovation. There are several reasons why these competitive ideals may not be realised in the superannuation market.

First and foremost, superannuation in Australia is based on compulsion, which can limit the demand-side pressure exerted by members. Member passivity and disengagement are further compounded by the complexity of retirement saving decisions, long time horizons, various behavioural and cognitive biases, and the costs of active involvement. At their core, these are **information problems** — incomplete information or asymmetric information — exacerbated by cognitive constraints.

The absence of strong member engagement can dull competitive pressure on superannuation funds, regardless of the presence of many funds in the market. Moreover, the information problems can create a risk of unhealthy and wasteful competition, such as excessive advertising and product proliferation.

Policy intervention can potentially improve on these outcomes by helping members make better choices, or via default selection processes reducing risk as members opt out of choice. Policymakers can also intervene on the supply side to steer competition and trustee behaviour to more beneficial aspects.

Default arrangements in Australia

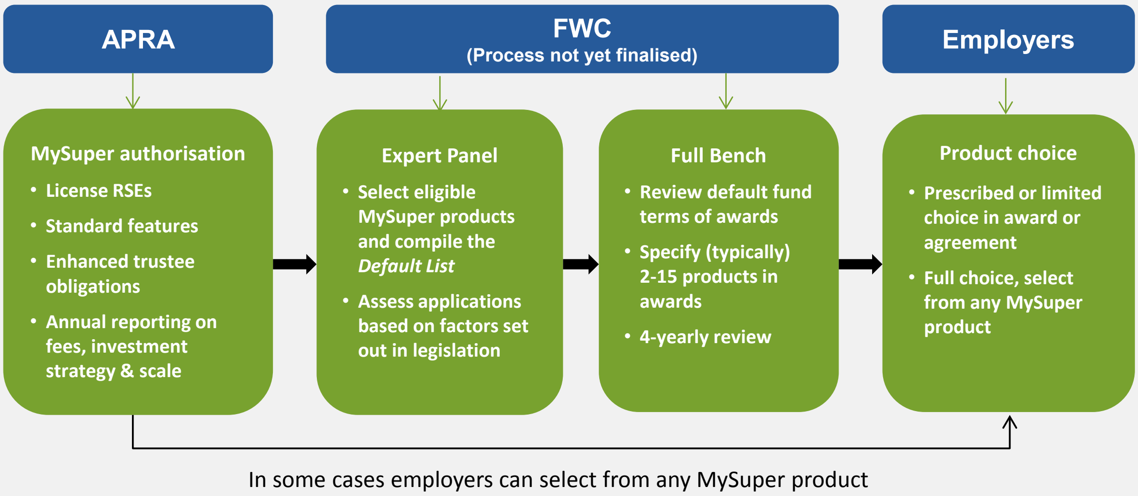
Defaults have been integral to the development of Australia's superannuation system, largely stemming from the decision to make superannuation compulsory and the inherent complexity for individuals in making decisions about retirement saving. Defaults also potentially reduce the cost and complexity for employers of complying with their

Superannuation Guarantee (SG) obligations. Most private pension systems around the world rely on defaults to some extent.

Box 1 Current default arrangements

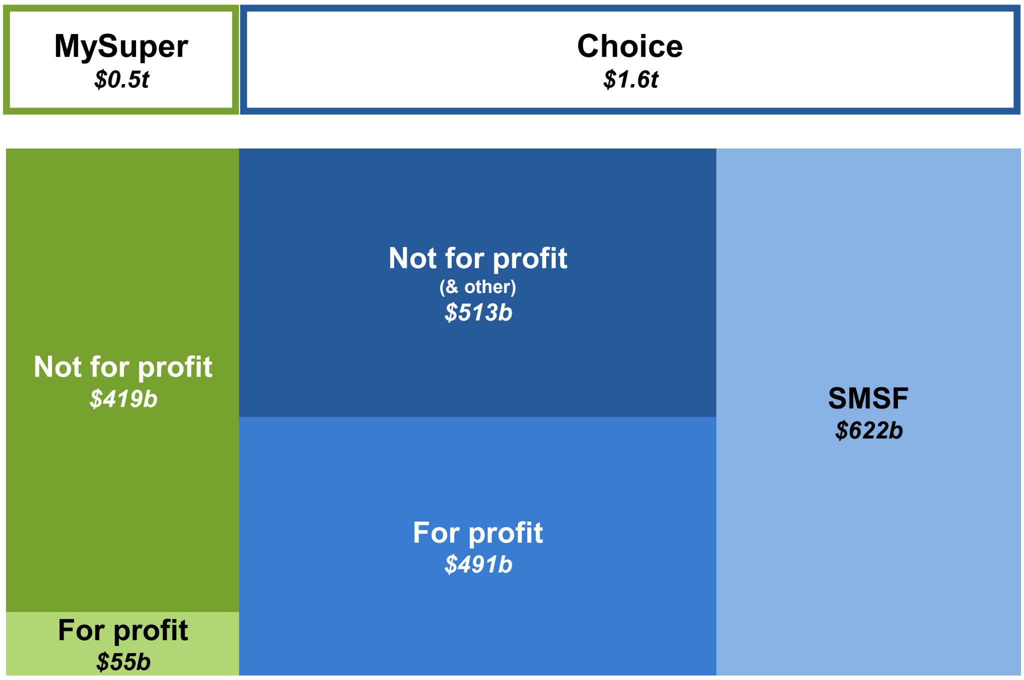
Under the *Superannuation Guarantee (Administration) Act 1992* (Cwlth), employers are required to make contributions to their employee's superannuation fund (with limited exemptions). Most employees have the opportunity to choose which fund these contributions are paid into. However, for those employees that do not make an active choice, employers are required to nominate a fund — which is thus the default fund. The rules surrounding this process vary significantly across industrial awards, agreements, contracts and other employment arrangements. Once a default fund has been selected, fund trustees are required to place default contributions into that fund's default product, which in most cases must be a MySuper product.

These arrangements are the result of historical workplace arrangements and the introduction of MySuper products as part of the Stronger Super reforms in 2013. In summary, there are up to four 'third parties' involved in the selection of default products for members that fail to make an active choice — the regulator (APRA), an expert panel within the Fair Work Commission (FWC), the full bench of the FWC and, finally, employers. These third parties have differing objectives and accountabilities. Employers in particular report disparate appetite and capability in selecting default funds for their employees.



The issue of default arrangements is highly contentious and politically sensitive. While defaults (MySuper products) only make up about a quarter of total superannuation assets (figure 2), they are more significant in terms of their share of members (putting a number on this is difficult due to systemic data gaps). Survey evidence suggests about two thirds of superannuation fund members stick with their default fund (and fewer than 5 per cent of members switch once they are in a fund). Opening up access to these members and their contributions is a lucrative proposition for new entrants and a competitive threat for incumbents (especially the relative poor performers).

Figure 2 **Size of the superannuation market, June 2016**



Other includes 'balance of life office statutory funds' and small APRA funds.

Some inquiry participants argued that the current default arrangements have served members well by placing them in funds with a culture of serving others and operating in the best interests of members, not shareholders or other related parties. In support of this view, many of these same participants highlighted empirical evidence of superior returns in not-for-profit funds relative to for-profit funds, and for default funds named in modern awards in particular. And while this is historically true *on average*, it does not hold for all industry funds.

Other participants, including retail funds, suggested that supply-side barriers (particularly in industrial awards and agreements) ultimately constrain competition and innovation which could benefit members. Moreover, they highlighted that even within the population of current 'no frills' MySuper products there is significant diversity in investment performance.

But it is unwise, as many have to date, to portray this Inquiry as just another 'industry fund versus retail fund' debate. This Inquiry is much more than that — it is a wake-up call to the entire industry, which some claim has become complacent with a steady flow of mandated contributions from disengaged members, and as an industry has failed to improve its scale and efficiency and deliver better outcomes for members (despite the MySuper reforms).

From this perspective, the Inquiry has managed to unite the superannuation industry against the Inquiry's potential contemplation of more-than-incremental reform. A healthy dose of scepticism would suggest that there must be rents to be recovered for the benefit of members for such unanimity to be valid.

Most participants from the superannuation industry argued that some form of default arrangements is needed for the foreseeable future (if not into perpetuity). Many participants voiced a familiar objection to the view that competition could promote member interests, instead placing faith in the goodwill and legal obligations of trustees. This Inquiry will test that proposition more fully.

How we developed the alternative models

Competition that merely sought to increase the already daunting number of choices (more than 110 MySuper products alone) would almost certainly do nothing to assist the potentially disengaged member, default or otherwise. Such is not, however, the paradigm for this Inquiry. The aim, as set by the Terms of Reference, is to determine if and how competition might make choice simpler or to lower the risk of not exercising choice.

There are various ways that a competition lens can inform the design of alternative models for allocating default members. Broadly, competition can be promoted in one of two ways:

- competition *in* the market — competition based on conventional demand- and supply-side interactions between employees (members) and trustees (funds)
- competition *for* the market — competition between funds via some form of formal process to earn the right to gain access to default members.

Promoting competition *in* the market needs consumers to make choices. While most employees already have the opportunity to choose which superannuation product their contributions are paid into, some employees are restricted from doing so (previously estimated to be in the order of 20 per cent of members). Freedom to make choices — which includes the freedom to make mistakes — is a necessary condition to realise the benefits of competition *in* the superannuation market. It is therefore essential to extend genuine member choice to all employees.

Promoting competition *for* the market may be desirable where it is not feasible to promote effective competition in the market, such as where member engagement is low or there are barriers to entry and exit. Typical ways to promote competition for a market include a tender or auction process.

The Commission has taken a broad interpretation of what constitutes a formal competitive process for the default market. It is any *new alternative* model that permits open participation, encourages rivalry between funds to the benefit of members, and involves products being selected for members based on merit.

There are three key steps to developing alternative competitive models:

1. specifying the market (*members* and *products*) to which the model applies
2. determining the type of selection mechanism for default products
3. determining the decision-making process for allocating members to those products.

The first step — what is the default market — is consistent across models and is discussed further below. The four models presented in this draft report differ on the second and third steps. The product selection mechanisms (step 2) are either administrative (such as a product filter based on certain standards) or market based (such as an auction). The distinction between administrative and market mechanisms is not necessarily stark: a 'heavier' filter, which includes relative performance standards, is very similar to a multi-criteria tender. The choice of the selection mechanism ultimately depends on the degree of filtering and who will be allocating members to products (step 3). The Commission has chosen the combinations that work well together.

Some models have not been considered in this Inquiry because they are not consistent with the competitive focus in the Terms of Reference — for example, a single sovereign fund that receives default contributions by fiat.

What is the market at stake?

The default member

Currently, an employee typically acquires a new default superannuation account every time they commence a new job and do not actively choose a fund themselves (the **turnover pool**). This creates a significant proliferation of accounts, with over 40 per cent of members holding more than one account.

This Inquiry is taking an alternative approach as suggested by the FSI in 2014: employees who fail to exercise choice[1] will be allocated to a default product only if they do not have an existing superannuation account. These would typically be new entrants to the workforce (the **first-timer pool**), and they will retain that account (including through a change in employer) unless they actively switch. Other employees who commence a new job would see their SG contributions flow to one of their existing superannuation accounts, or a new account of their choice.

There would be about 400 000 new default members each year under the Commission's first-timer definition, with about $800 million in annual contributions. This is evidently much lower than the contributions in the turnover pool. This pool, while being hard to

[1] None of the models presented in this report mandate that employees join or remain with a particular default product. Employees would have the right to choose their own fund and product, and to switch funds or products after joining.

estimate because of systemic data gaps, would have more members (in the short term) and higher average incomes.

Nonetheless, the first-timer pool is not insignificant, particularly in the medium term. A key reason for its initial modest size is that the average income of first-timer members is about $21 000 (which reflects the part-time or casual nature of many first jobs). Contributions from each year's cohort would grow at a faster rate than for people in the turnover pool as they converge towards average incomes; applying average incomes to this cohort yields a pool of just over $2 billion. These younger members would likely remain in their original product for a longer period, and thereby offer successful funds the benefits of improved inflow–outflow ratios and thereby readier liquidity management.

In this draft report, the Commission is keen for participant feedback on the proposal to restrict the default models to people who do not already have a superannuation account, and what this implies for the competitive dynamics of any alternative model. For example, which funds would not compete for this default pool, and why not? The impact on funds heavily dependent on constant inflows of default members might at first glance appear self-evident but in the Commission's thinking this might be wrong. The presence or absence of complementary reforms to barriers affecting choice appears likely to make some difference.

The key benefit of restricting the new default allocation models to the first-timer pool is the immediate 'circuit breaker' of reducing wasteful account proliferation, which erodes member balances via multiple sets of fees and insurance policies. The FSI found that addressing account proliferation and lost accounts could increase superannuation balances at retirement by around $25 000. Multiple accounts are especially problematic among younger members, for whom it is less likely to be a deliberate outcome. This erosion is further exacerbated where young members have inappropriate insurance policies with their superannuation funds. Overall, account proliferation is one of the superannuation system's worst systemic failings and warrants more than the incremental remediation to date.

This approach is contingent on universal use of a centralised online information service to enable employers to identify which employees do not already have an existing account and to facilitate members to consolidate their accounts. At a system level, this service will generate information about employee decisions that will fill important evidence and data gaps for future policy decisions. The ATO is currently developing platforms that might be adaptable to the task.

A centralised clearing house[2] would bring additional member (and efficiency) benefits to the superannuation system, as evident in New Zealand with the role played by the Inland Revenue Department. These benefits include administrative simplicity for employers and funds, which makes it more attractive to new entrants, and easier oversight of employer

2 Whereby employers would remit all superannuation contributions directly to the clearing house, with the clearing house then transferring those contributions to the relevant superannuation funds.

compliance with SG contributions. A clearing house will be explored further in the stage 3 review.

Implications for existing default members

While this Inquiry's focus is on how to allocate *new* default members, any new allocation process poses the question of how to treat the large stock of *existing* default members. How these existing members are treated has implications for competitive dynamics, as well as broader system efficiency and fairness.

A fund whose product 'wins' default status for contributions of *new* default members would have to extend the same fees and service terms to its *existing* members in the default product. This would be simple and fair — it would avoid a situation where funds have multiple tiers of default members, each in a different product or fee structure — and was broadly supported by inquiry participants. It would also spread the benefits of competition to a wider cohort of default members. But the models in this report do not envisage moving the *entire system's* pre-existing default members to the new default product. This avoids material upheaval, with the potential for near-term instability, in the superannuation system.

The default product

The bundle of superannuation services (the default product) to which default members would be allocated is also common to all models, and pertains to the accumulation stage only. The default product should be simple, providing the minimum services necessary to meet the Government's stated objective for superannuation — to provide income in retirement to substitute or supplement the Age Pension.

These would include investment, administration of member accounts and intrafund advice. The administrative services and intrafund advice should help members understand the superannuation system and be informed about the performance of their investment product, the fees they are paying, the intrafund switching options and the process for exiting the fund. Importantly, the quality or range of ancillary services per se should not be the main driving factor in selecting default products under any of the allocation models. Funds should primarily compete on long-term net returns and fees for a threshold level of service.

The alternative models will be evaluated on the quality of their default *superannuation product* only — and not on insurance, which is currently bundled with default superannuation on an opt-out basis. In this environment, insurance is best dealt with as a regulatory add-on. The Commission will assume that the trustee chooses to bundle the default superannuation product with insurance, subject to meeting their fiduciary and legislative obligations, but the models do not involve comparing the quality or price of bundled insurance.

The Commission has noted the various tensions of bundling insurance with superannuation in its stage 1 report, and it should also be self-evident to trustees that the Government's stated objective for the superannuation system does not envisage insurance as an essential element of the system.

The assessment framework

Each model in this draft report has been assessed against five criteria and the assessment is mostly qualitative, given the developmental nature of this Inquiry. The assessment framework was informed by the Terms of Reference and the Commission's overarching objective to promote the wellbeing of the Australian community *as a whole*.

- **Member benefits:** Does the model create incentives for funds to maximise long-term net returns and allocate members to products that meet their needs?
- **Competition:** Does the model encourage open participation (contestability) and rivalry between funds (competition) to drive innovation, cost reductions and more efficient long-term outcomes for members?
- **Integrity**: Does the model promote a high-degree of integrity in the selection and delivery of default superannuation products, and the ongoing behaviour of superannuation funds more broadly?
- **Stability**: Is the model likely to create instability in the superannuation system that leads to significant systemic risks?
- **System-wide costs**: Does the model minimise overall system-wide costs, taking into account costs on members, employers, funds and governments?

There was broad agreement among inquiry participants that members' best interests should be paramount in the assessment. In many (if not most) cases, a model that promotes members' best interests could also be expected to promote the wellbeing of the Australian community.

The assessment of alternative models requires a common reference point or **baseline** for comparison. The Commission is using the baseline of no default arrangements. This proposal elicited a substantial amount of participant feedback, which fell into two broad categories: participants who wanted the models compared to current default arrangements, and participants who interpreted the no-defaults baseline as an alternative model. Neither interpretation is correct.

The no-defaults baseline is not an alternative model in its own right. Rather, the Commission considers this to be as close as is possible to an objective starting point from which to identify the problems that occur in a no-defaults world (the raison d'être of a default system is to address these).

It is also the baseline that can best expose the *relative* abilities of alternative models to address the problems of the default cohort today, rather than past problems and perception, some of which may no longer be relevant. The alternative models need to beat the baseline against the assessment criteria to be considered viable, then prove workable.

What does the baseline look like?

The baseline is a world of **unassisted active choice**. In the baseline, employers must make SG contributions on behalf of employees. Superannuation funds and products would be subject to prudential, competition and consumer laws and regulations. Employees would be required to choose a superannuation product to receive their contributions. There would be unrestricted choice, but with regulations — employees can choose from any publicly offered *legally complying* superannuation product available in the market (including a self-managed fund).

Employees would be responsible for researching and evaluating available products themselves, albeit with the potential to seek support from third parties of their own initiative — such as employers, unions, financial advisers and ratings agencies. Employers, unions and other intermediaries would also be free to bargain with superannuation funds on behalf of employees to secure group discounts. This would mimic the current practice offered by corporate funds or industry funds, the only difference being that employees would need to actively choose that fund.

… And how does it perform against the assessment criteria?

Some employees would struggle to make good long-term decisions in this unassisted active choice world. In particular, they may choose products with high fees or poor investment performance, or pay for additional services (such as a plethora of investment options) they may not need. Further, some employees may choose overly conservative products, reducing their potential retirement income. Importantly, and unlike poor consumer choices in other markets, these costs extend beyond the employee to also be borne by future taxpayers, to the extent that they result in higher Age Pension reliance.

In contrast, a significant benefit of the baseline — which is less evident under default arrangements — is that requiring employees to interact with their superannuation and make an active choice can potentially drive member engagement and ultimately exert competitive forces.

The baseline is considered the purest form of competition, albeit operating in a highly regulated market. The supply side of the market is likely to be highly contestable, with low barriers to entry and exit, and low levels of market concentration. Rivalry between funds is expected to drive innovation over time. However, there is also scope for unhealthy and wasteful competition in the form of superfluous product differentiation and inducements, and excessive advertising.

An unassisted active choice world minimises the number of principal–agent relationships that can lead members astray. That said, potential for conflicts of interest still exists in an unassisted active choice world, primarily where members seek advice from other parties.

The baseline is unlikely to have a destabilising effect on the superannuation system. There would be no reason to expect sudden large-scale changes in the flow of members or assets between funds, or excessive market concentration.

In an unassisted active choice world, members bear most of the costs of allocating themselves to a relevant superannuation product (largely search costs, though some are likely to put in more time and effort than others). While this may not be significant at the individual level, it may be cumulatively significant across the entire system. Costs for other system participants (for example, employers) are expected to be low.

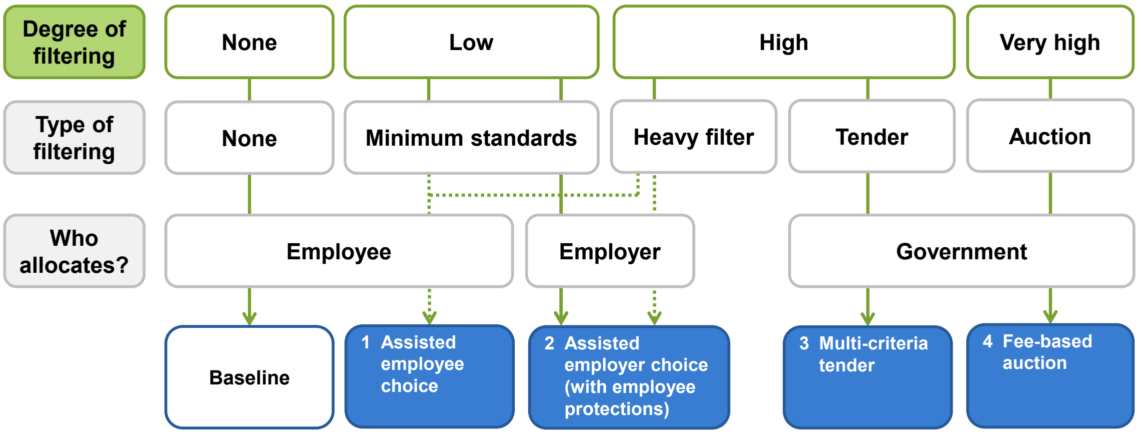
The Commission is undertaking an experimental survey of superannuation decision making which will further add to this evidence base. The results and analysis will be made publicly available (upon completion) and will also be incorporated in the Commission's final report.

The alternative models in brief

As noted earlier, information problems are at the core of the market failures in superannuation. There are only two pathways to address information problems: increase the availability and quality of information (at a cost) or limit choice to a smaller set of better products. The Commission has developed four new alternative models that do this in some way (figure 3). The key features of each model are noted briefly below, and additional detail about each of the models can be found in their corresponding chapters.

- **Assisted employee choice** — this model leverages the competition benefits that arise when members exercise choice, but with information and nudges to assist members to make informed choices.
- **Assisted employer choice (with employee protections)** — this model injects competition by giving employers choice in selecting a default product for their employees, as long as the default product meets some minimum standards, while also simplifying choices for small and medium sized businesses.
- **A fee-based auction and a multi-criteria tender** — these models incorporate a market-based mechanism into the selection of default products, with sequential allocation of members among winning products.

Figure 3 **The building blocks of the allocation models**



Model 1: Assisted employee choice

In this model, employees are required to choose a superannuation product themselves (active choice), but are assisted in doing so by a set of policy interventions.

- The primary feature is a non-mandatory **shortlist** of carefully selected products that are deemed to be 'good'. It would nudge employees towards good products without going as far as to impose one by default. The shortlist would consist of between 4 to 10 products, selected by a government body using a heavy administrative filter (see model 2). The shortlist would be accompanied by simple information on key features of each product in a consistent and comparable format.
- A system of **product accreditation** would encourage funds to provide products which have a common, simple design that allows for easy comparisons across different products, and thereby makes it easier for employees to choose a product that meets their needs. Product accreditation would be voluntary for funds and be akin to a strengthened MySuper authorisation process (with a stronger emphasis on minimum performance standards). Products would have to be accredited to be considered for shortlisting.
- A simple, low-cost **last-resort fund** (run by existing eligible rollover funds or possibly the Future Fund) would hold contributions from employees who fail to exercise choice and encourage them to choose their own product.

Model 2: Assisted employer choice (with employee protections)

In this model, employers choose a default product for their employees who do not exercise choice. In doing so, employers *must* select a product from one of two lists. The model recognises that some (mainly larger) employers are well placed to choose a default product and negotiate favourable arrangements for their employees, while many (mainly small and medium size) employers are not well placed to select a default product.

- Employers must choose a product that meets mandatory minimum standards: a **light filter**. Mandatory minimum standards are important to protect member interests, given the principal–agent issues inherent in the employer choice environment. The light filter would be akin to a strengthened MySuper authorisation process (with a stronger emphasis on minimum performance standards).
- A **heavy filter** would apply stricter criteria around investment performance and other product features (similar to the tender criteria below) to identify a narrower ‘preferred default’ list of the best performing products. The preferred default list would be voluntary for employers, and is designed to assist employers who are not well placed to select appropriate default products for their employees.

Model 3: Multi-criteria tender

In this model, participants compete for rights to a share of the default pool by making proposals against a number of different assessment criteria, which are weighted by their relative importance. A well designed multi-criteria tender could therefore engender a product that performs well on multiple characteristics that meet members’ needs. The key features of this model are:

- a **pre-qualification stage** to ensure participating funds meet minimum criteria relating to governance and transparency
- the **tendering stage**, where participants submit tenders against the following criteria:
  - past performance on net returns and member satisfaction
  - investment strategy
  - the quality of member services, engagement and intrafund advice
  - fee levels and transparency
  - innovation in unspecified areas
- a **comparative evaluation stage** — tenders are evaluated against the criteria and assigned an index score, with up to 10 of the overall best performers being deemed as winners of the tender. A best-and-final-offer stage could be used to encourage convergence where proposals are close, in the interest of members having near equivalence in standards despite being sequentially allocated to a product
- a **performance monitoring and enforcement stage**, with winning providers self-reporting against the commitments made in their winning offers, and a credible threat of losing default provider status in the absence of immediate remediation of a contractual breach.

Box 2 Who would run the selection process?

All of the models require a selecting body. Because of the competitive assessment nature of the exercise, this body should not be a regulator like APRA or ASIC. The selecting body (or panel) would be established specifically for the selection task each round, and then cease operations — it would have no ongoing role. The selecting body would be overseen by and accountable to the Australian Government. While this places some of the responsibility for the outcomes on the government and so may increase perceived moral responsibility by the government for later poor performance, this is necessary to ensure the integrity and credibility of the process. Government administration of the process should not preclude private-sector participation in an advisory sense.

There are a number of key principles that are relevant to the composition and conduct of this selection body:

- an obligation to act in the best interests of fund members
- an understanding of the needs of default members and how these are best met
- sufficient expertise and knowledge of superannuation and finance
- transparent processes
- procedural fairness (that is, enabling all relevant parties to participate equally)
- being dispassionate and free of conflicts of interest
- being accountable for its decisions and having credibility with members and funds.

The product selection process should be repeated every four years in the early stages of the operation of the allocation model. The frequency can be reduced in the future.

Model 4: Fee-based auction

This model has products competing for default status by out-bidding each other on member fees. A fee-based auction is worthy of consideration for two reasons. First, there is evidence that variation in member fees explains a significant amount of variation in net returns. Second, realising economies of scale would allow the superannuation system to achieve lower member fees without diluting net returns. While both points may be contested, they are not without merit.

- A **pre-qualification stage** is used to ensure participants meet certain minimum standards. Fund-level minimum standards relate to the fund's integrity and capacity to handle expected member inflows. Product-level standards relate to a certain level of member and investment services.
- The auction's **bidding metric** is a composite fee that accounts for administration and investment fees, as these make up the bulk of member charges. The **bidding format** is a first-price sealed-bid.
- The auction would be able to produce **multiple winners** (but also a single winner). The advantage of multiple winners is the wider spread of the lowered fee across the market (noting the requirement cited earlier that winning funds must extend the new fee to

their existing members of the default product). This would be done through a carefully managed best-and-final-offer mechanism, whereby a select number of losing funds may have an opportunity to match the fee and service offering of the winner.

- Post-auction **monitoring and enforcement** mechanisms will be needed to keep the winning fund(s) to the commitments made in the auction process, including a credible threat of losing default provider status in the absence of immediate remediation of a contractual breach.

Assessing and comparing the models

This section compares how the four alternative models compare to the baseline of unassisted active choice. Unsurprisingly, all of the alternative models outperform the baseline on **member benefits**, because they guide more members to better performing products.

- Models that involve a multi-criteria tender or heavy filter perform relatively better, as their multifaceted selection framework will more comprehensively reflect member needs.
- There is a risk under the fee-based auction that winning funds will eschew higher-cost illiquid assets, which have been credited with providing superior diversification and net returns in the past to some funds. Nonetheless, putting young disengaged members into a low-cost passive fund may be a reasonable choice, which many overseas default models apply (albeit with many combining passive with conservative investment strategies).
- The models with defaults could deter some employees (with moderate levels of engagement and literacy) from actively researching products themselves. The higher level of member engagement in the baseline is better maintained in the assisted employee choice model.

All of the models also outperform the baseline on **competition**, because they focus competition on aspects of member value.

- The models that centralise allocation decisions in the hands of government (auction, tender and heavy filter) have high levels of filtering and therefore focus competition *for* the market on the factors that matter for members, at least in the short to medium term.
- The models with employee or employer choice have high competition *in* the market (due to a large number of both buyers and sellers). Any models that have high competition *in* the market will invariably have high marketing costs and some scope for unhealthy and wasteful competition (but less than the baseline). But this type of competition is healthier in the long term, because it is better able to innovate and anticipate shifts in consumer needs.

All of the models bring new parties into the decision-making process compared to the baseline, some more so than others. This will unavoidably introduce conflicts of interests undermining **integrity**.

- The auction, tender and heavy filter models put a significant onus on government to get the selection right. This invariably heightens the risk of getting it wrong — a lot rests on the integrity of the selection body and process. There is a risk that the selection process will be too conservative, or try to be all things to all people. And this is apparent from international experience.
  - These risks are probably smallest for the fee-based auction because of its relative simplicity. The complexity of weighing multiple criteria may create a perception (or reality) that the preferred list panel moves to a lowest common denominator and fails to objectively and robustly evaluate products.
- Additional integrity concerns arise in models with employer choice, particularly given the implausibility of imposing a regulatory obligation upon employers to act in their employees' best interests.
- But the models can also promote integrity by reducing scope for exploitative behaviour that can occur in the presence of compulsion and complexity. The additional consumer protections and the selection processes can build trust and confidence in funds and the system. Moreover, the accountability and transparency mechanisms embedded in each model are likely to be more effective in holding funds to account than unassisted active choice.

No model is expected to introduce excessive levels of market concentration or unmanageable risks to the **stability** of the system.

System-wide costs under all of the models are either similar or slightly lower than the baseline — a simple function of the smaller decision making cohort. All of the models reduce search costs for members and, because the set of choices is narrowed under all models, there are likely to be reductions in system-wide marketing costs. This will be offset to some extent by additional costs associated with selection processes and consumer protections.

- The models with mandatory minimum standards or product accreditation (assisted employer choice (with employee protections) and assisted employee choice) have relatively higher costs because these models require ongoing regulatory oversight of a potentially large number of products.
- System-wide costs are likely to be lower for the auction and tender. The cost of a quadrennial selection exercise is likely to be small, and would require self-reporting and monitoring of only a small number of products.

Draft findings and recommendations

DRAFT FINDING 1.1

Complementary policy action (including to extend genuine member choice to all employees) will be needed to deliver the full potential of member-driven competition under the alternative models developed in this Inquiry and also under current default arrangements.

DRAFT FINDING 1.2

Where there is third-party involvement in the selection of a default product, there needs to be effective regulation or arrangements in place to ensure these third parties act in the best interests of members.

DRAFT FINDING 1.3

For the purposes of this Inquiry, a formal competitive process for allocating default members constitutes any new alternative process that permits open participation (contestability), encourages rivalry between funds (competition) to the benefit of members, and involves products being selected for members based on merit.

DRAFT FINDING 3.1

The current arrangements where members can be defaulted to a new account on every change of job increases the proliferation of accounts. This materially adds to costs for members and reduces member balances at retirement.

DRAFT RECOMMENDATION 3.1

To avoid perpetuating the legacy problems of the current system, any future alternative system for allocating members to default products should be premised on employees being assigned a default product only once, when they join the workforce.

DRAFT RECOMMENDATION 3.2

The Australian Government should establish a centralised online service for members, employers and the Government that builds on existing functionality of myGov and Single Touch Payroll. The service should:

- allow members to register online their choice to open, close or consolidate accounts when they are submitting their Tax File Number on starting a new job
- facilitate the carryover of existing member accounts when members change jobs
- collect information about member choices (including on whether they are electing to open a default account) for their employer and the Government.

There should be universal participation in this process by employees and employers.

DRAFT FINDING 3.2

There are strong grounds for requiring a fund that wins default status for contributions of new default members to extend the same fees and service terms to all its existing members of the default product.

DRAFT FINDING 3.3

The default product in all models will focus on the accumulation stage and include investment, administration of member accounts and intrafund advice. It will be a simple and low-cost (but not conservative) product aimed at the needs of those who are disengaged from the system.

- A bundled insurance product will not be a factor in the selection of products and is best addressed through regulation and regulator oversight.
- Funds will primarily compete on long-term net investment returns and costs, subject to meeting a threshold quality of service, not on the quality or range of ancillary services per se.

DRAFT FINDING 3.4

The desirable frequency for the selection process is between four and eight years, with the greater frequency best used in the early period.

DRAFT FINDING 3.5

The selection of eligible default products should be administered by a government body, and be subject to strong governance rules. The decision-making body must:

- have a strong focus on fund member interests
- have sufficient expertise to evaluate products
- be independent and free of real or perceived conflicts of interest
- have processes that are transparent and afford procedural fairness
- be accountable for its decisions.

DRAFT RECOMMENDATION 3.3

The Australian Government should introduce a formal framework that specifies the process and obligations of trustees when making or considering merger proposals. As part of the framework, trustees would be required to disclose all merger attempts involving their fund, as well as the reasons for any decisions.

DRAFT FINDING 5.1

Relative to the baseline, the assisted employee choice model would:

- significantly reduce the complexity employees face in choosing a product and lead to more employees choosing high-performing products that meet their needs, thereby increasing member benefits
- focus competition on product aspects of value to members, put downward pressure on fees (through greater product comparability) and likely curtail wasteful product proliferation
- better align funds' interests with those of members
- support a stable superannuation system
- have lower search costs for many employees and very low costs for employers, but with government and funds incurring additional costs associated with regulatory structures.

DRAFT FINDING 6.1

Relative to the baseline, the fee-based auction model would:

- promote member benefits by exerting downward pressure on fees
- focus competition on, and elevate transparency of, member fees
- likely assist integrity due to its simplicity and accountability mechanisms
- be unlikely to compromise long-term stability because the model as designed would not lead to excessive concentration of funds or volatile movement of members and assets
- have slightly lower system-wide costs, mainly due to lower search costs for members.

DRAFT FINDING 7.1

Relative to the baseline, the multi-criteria tender model would:

- promote member benefits by focusing competition on member satisfaction and long-term net returns
- focus competition on aspects of performance that matter to members, and more generally through the winning bid providing a market-wide performance benchmark
- create risks for integrity due to its vulnerability to subjective judgments, yet on the other hand promote integrity through stronger accountability mechanisms
- not create any material risks to stability, since it is unlikely to lead to excessive concentration or volatile movement of members and assets
- have slightly lower system-wide costs, mainly due to lower search costs for members.

DRAFT FINDING 8.1

Relative to the baseline, assisted employer choice (with employee protections) — employing both a light filter for mandatory minimum standards and a heavy filter for a preferred default list — would:

- enhance member benefits by increasing the likelihood of members being placed in higher quality products, and reducing the likelihood of them being in a poor product
- promote healthy competition by presenting product providers with incentives to perform strongly against the preferred list selection criteria or compete for corporate tenders and facilitating greater comparability, but there would still be some scope for unhealthy and wasteful marketing to employers
- increase the potential for agency problems given the involvement of employers, although the risk to the integrity of the system would lie primarily in the appointment process for the preferred default list selection panel
- create few stability concerns
- reduce search costs for employees, while increasing search costs for employers and regulatory costs for funds and government.

Information requests

INFORMATION REQUEST 3.1

The Commission is seeking comment from the industry on the effect on fund participation in the competitive process of moving to the first-timer pool of default members.

- *Are there any funds that might choose not to participate due to the lower value of the pool, and what is the threshold minimum pool size (per fund) at which this might happen?*
- *How would the move to a first-timer pool of default members affect the fees and product features that funds would offer when competing for new members?*

INFORMATION REQUEST 3.2

The Commission is seeking feedback on the merits and implementation issues of its proposal to improve transparency around fund merger activity.

- *What (if any) complementary regulatory action would be needed to ensure that the framework is effective in promoting mergers and the exit of underperforming funds?*
- *Are there any likely unintended consequences from introducing the proposed framework? To what extent and how could those unintended consequences be addressed through policy design?*

INFORMATION REQUEST 3.3

The Commission is seeking comment on its approach to, and alternative ways of estimating the size and value of, the turnover and first-timer pools and the benefits from reducing account proliferation due to moving to the first-timer approach.

INFORMATION REQUEST 5.1

In terms of a shortlist of superannuation products, what evidence is available on the size of the list that would best facilitate the majority of employees to choose a fund that meets their needs?

What specific information should be included alongside such a shortlist to help employees to choose between products? In what format should the information be presented? What evidence is there for how the metrics would assist employees to make decisions?

What institutional arrangements would best suit a last-resort fund? Should it be managed by existing eligible rollover funds or the Future Fund?

Under a system of active employee choice, what would be the costs and benefits of prohibiting funds or related parties from offering prospective members a short-term benefit that is unrelated to the superannuation product? What specific form should any such prohibitions take?

INFORMATION REQUEST 6.1

Is the format of a first-priced sealed bid with a best-and-final-offer stage and potentially multiple winners the best fit for a fee-based auction? Are there any risks associated with these design elements that have not been identified?

Regarding transparency, what would fall under the exemption of information that, if it were disclosed, could reasonably be expected to have commercially adverse consequences for the bidder?

Could a fee-based auction be designed to facilitate second-order competition between funds on non-fee aspects of performance, such as member services?

INFORMATION REQUEST 7.1

Which aspects of member services should be included in the tender criteria? Do default members value the same services as choice members?

How should default members be allocated across the set of winning products? Are there problems with sequentially allocating members into products with different investment strategies, fees and services, as is implied by this model? What role could a best-and-final-offer stage play in providing a select number of funds the opportunity to improve their offer?

Regarding transparency, are there any problems with only withholding information that can reasonably be shown to be commercially sensitive? What information would fall under this exemption?

INFORMATION REQUEST 8.1

What are the main drivers of costs to employers in selecting default products on behalf of their employees? Would a shortlist of preferred default products make this task easier for employers? Is there an ideal minimum number of products that should be nominated on the preferred default list?

Are there other specific criteria in addition to those proposed under the minimum standards criteria that default products should meet to protect members and help to achieve better outcomes for them in the long term?

Would a dual-list approach, allowing employers to select a product from one of two lists, provide them with sufficient flexibility to select tailored default products that best meet the needs of their employees?

Which types of employers prefer to retain a role in default product selection? To what extent are default products or corporate fund offerings considered important benefits offered to prospective employees in competitive labour markets?