



Australian Government
Productivity Commission

Superannuation: Alternative Default Models

Productivity Commission Issues Paper

September 2016

The Commission has released this issues paper to assist individuals and organisations to prepare submissions.

It contains and outlines:

- the scope of the inquiry
- the Commission's procedures
- matters about which the Commission is seeking comment and information
- how to make a submission.

The Issues Paper

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- the scope of the inquiry
- the Commission's procedures
- matters about which the Commission is seeking comment and information
- how to make a submission.

Participants should not feel that they are restricted to comment only on matters raised in the issues paper. The Commission wishes to receive information and comment on issues which participants consider relevant to the inquiry's terms of reference.

Key inquiry dates

Receipt of terms of reference	17 February 2016
Due date for submissions	28 October 2016
Release of draft report	March 2017
Public hearings	May 2017
Final report to Government	August 2017

Submissions can be lodged

Online:	http://www.pc.gov.au/inquiries/current/superannuation/alternative-default-models
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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).

Terms of reference

EFFICIENCY AND COMPETITIVENESS OF THE SUPERANNUATION SYSTEM

I, Scott Morrison, Treasurer, pursuant to Parts 2, 3 and 4 of the Productivity Commission Act 1998, hereby request that the Productivity Commission conduct: a study to develop criteria to assess the efficiency and competitiveness of the superannuation system; and an inquiry to develop alternative models for a formal competitive process for allocating default fund members to products.

Background

An efficient superannuation system is critical to help Australia meet the economic and fiscal challenges of an ageing population. The superannuation system has accumulated over \$2 trillion in assets. Given the system's size and growth, the system is of central importance to funding the economy and delivering retirement incomes.

MySuper has been a strong step in the right direction but more needs to be done to reduce fees and improve after-fee returns for fund members. The Financial System Inquiry noted that fees have not fallen by as much as would be expected given the substantial increase in the scale of the superannuation system, a major reason for this being the absence of consumer-driven competition, particularly in the default fund market.

These Terms of Reference follow from the Government's response to Financial System Inquiry Recommendation 10 on efficiency in superannuation. The Government committed to tasking the Productivity Commission to develop and release criteria to assess the efficiency and competitiveness of the superannuation system, including the choice and default markets and to develop alternative models for allocating default fund members to products.

This work will inform a review of the efficiency and competitiveness of the superannuation system, which the Productivity Commission will be asked to undertake following the full implementation of the MySuper reforms (after 1 July 2017).

Process

The Productivity Commission is to develop criteria to assess the efficiency and competitiveness of the superannuation system and release the criteria within nine months of receiving these Terms of Reference. The release of these criteria is intended to provide transparency and certainty to the superannuation industry about how it will be assessed ahead of the full implementation of MySuper.

The Productivity Commission is to develop alternative models for a formal competitive process for allocating default fund members to products. In developing alternative models,

the Productivity Commission should be informed by the criteria it develops to assess the efficiency and competitiveness of the superannuation system. The Productivity Commission should report on alternative models within 18 months of receiving these Terms of Reference.

For both elements, the Productivity Commission should consult widely and undertake appropriate public consultation processes, including inviting public submissions and conducting industry roundtables. The Productivity Commission is to provide both draft and final reports and the reports will be published.

Scope of study: development of criteria to assess efficiency of super system

The Productivity Commission should develop criteria to assess whether and the extent to which the superannuation system is efficient and competitive and delivers the best outcomes for members and retirees, including optimising risk-adjusted after fee returns. In determining the criteria to assess the efficiency and competitiveness of the superannuation system, the Productivity Commission may have regard to:

- operational efficiency, where products and services are delivered in a way that minimises costs and maximises value, which can be enhanced by competition and innovation from new entrants and incumbents;
- allocative efficiency, where the system allocates resources to the most productive use and optimally allocates risks;
- dynamic efficiency, including services to members, where the system induces the optimal balance between consumption and saving over time; and
- the extent to which the system encourages optimal behaviour on the part of consumers, including consideration of the learnings from behavioural finance.

The Productivity Commission should consider the nature of competition in the superannuation industry, the effect of government policy and regulation on the competitiveness and efficiency of the system and relevant international experience.

Scope of inquiry: development of alternative models

The Productivity Commission is to examine alternative models for a formal competitive process for allocating default fund members in the superannuation system to products and to develop a workable model, or models, that could be implemented by Government if a new model for allocating default fund members to products is desirable. These model(s) would provide viable alternatives for the Government's consideration, depending on the outcomes of the review of the efficiency and competitiveness of the superannuation system, which the Productivity Commission will be asked to undertake following the full implementation of the MySuper reforms.

The developed model(s) should enhance efficiency in the superannuation system in order to improve retirement incomes, including through optimising long-term net returns to members, and build trust and confidence in funds regulated by the Australian Prudential Regulation Authority (APRA). The models developed should consider default fund selection across the superannuation system as a whole.

The Productivity Commission may consider auction, tender and other types of competitive processes. The Productivity Commission should consider the merits of different approaches, the metrics for conducting them and their frequency. This should include consideration of:

- the strengths and weaknesses of competitive processes used internationally, such as Chile, New Zealand and Sweden, as well as those used in large corporate tenders by the Northern Territory Government and in other jurisdictions;
- the costs and benefits of different mechanisms, including:
 - optimising long-term after fee returns;
 - the administrative, fiscal, individual and complexity costs;
- and in examining different processes, consider:
 - the robustness of the process, including against gaming and collusion;
 - whether the structure achieves efficient outcomes and facilitates ongoing innovation over the long run;
 - the effect on system stability and market concentration;
 - who should run the process; and
 - the extent to which the process promotes the interests of consumers.
- regulatory impediments to optimal competition under the preferred model(s).

Principles for designing a model for a competitive process should include:

- **Best interests:** ensure incentive compatibility with meeting the best interests of members, encourage long-term investing, and encourage a focus on expected after-fee returns based on asset allocation and investment strategy.
- **Competition:** drive pressure on funds to be innovative and efficient, diversify asset allocation and optimise long-term after-fee returns by rewarding best performers. Facilitate new superannuation fund entrants to the market.
- **Feasibility:** ensure the process is low-cost and easy to administer and minimises regulatory costs on industry, including business and employers.
- **Credibility and transparency:** make relevant information public; avoid room for gaming the process; and ensure metrics are clear, simple, difficult to dispute and difficult to manipulate.

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- **Regular assessment and accountability:** regularly conduct a repeat process that requires default funds to earn their right to receive new default members, and ensure funds are accountable for the outcomes they deliver members.
 - **Fiscal implications:** the extent to which the process can reduce reliance on the Age Pension and/or give rise to other risks or costs to Government.

The Productivity Commission should draw on expertise in the field of competitive models.

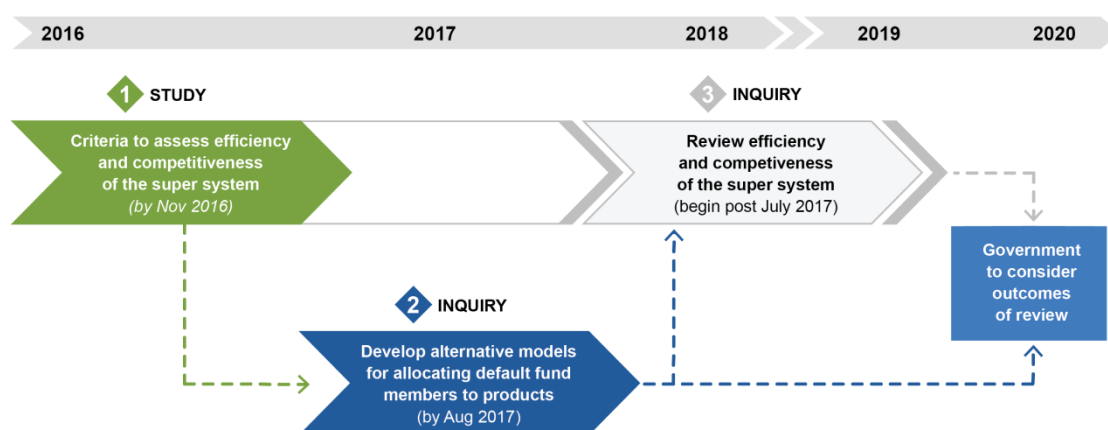
S. MORRISON
Treasurer

[Received 17 February 2016]

1 What is this inquiry about?

This inquiry represents the second of three related pieces of work to be undertaken by the Productivity Commission (figure 1) stemming 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 sector. To improve operational efficiency during the accumulation phase of superannuation, the FSI recommended the introduction of 'a formal competitive process to allocate new default fund members to MySuper products', unless a review by 2020 finds such a move would be unnecessary (Murray et al. 2014, p. 101).

Figure 1 Three-stage superannuation review



The purpose of this inquiry (stage 2) is to examine alternative models for a formal competitive process for allocating default fund members in the superannuation system to products and to develop a workable model, or models, that could be implemented by Government if a new model for allocating default fund members to products is desirable. As the inquiry will look at default fund selection across the superannuation system as a whole, it is broader in scope than the Commission's 2012 inquiry looking at default funds in modern awards (PC 2012).

Importantly, the emphasis is on *developing alternative models*. This inquiry is not a review of MySuper or other current default arrangements. In assessing alternative allocative models, this inquiry will therefore be starting from an objective baseline scenario of no defaults. The efficiency and competitiveness of the current system will be reviewed in stage 3, which the Commission will be asked to undertake following the full implementation of the MySuper reforms (that is, after 1 July 2017).

How you can contribute to this inquiry

The Commission will consult through stakeholder visits and accepting submissions from all interested parties. Participants can also make brief comments on the Commission's website. Public hearings will be held after the release of the draft report.

The Commission encourages submissions on issues relevant to the inquiry's terms of reference. This issues paper has been released to assist participants in preparing submissions. It is not a requirement that participants answer all the questions in the issues paper, restrict their submissions to the issues identified, or present their submissions in a question and answer format. However, the Commission requests that submissions focus specifically on the terms of reference for this inquiry. There will be opportunities to make further submissions following the release of the draft report.

Submissions should be provided to the Commission no later than **28 October 2016**. Attachment A provides further details on how to make a submission.

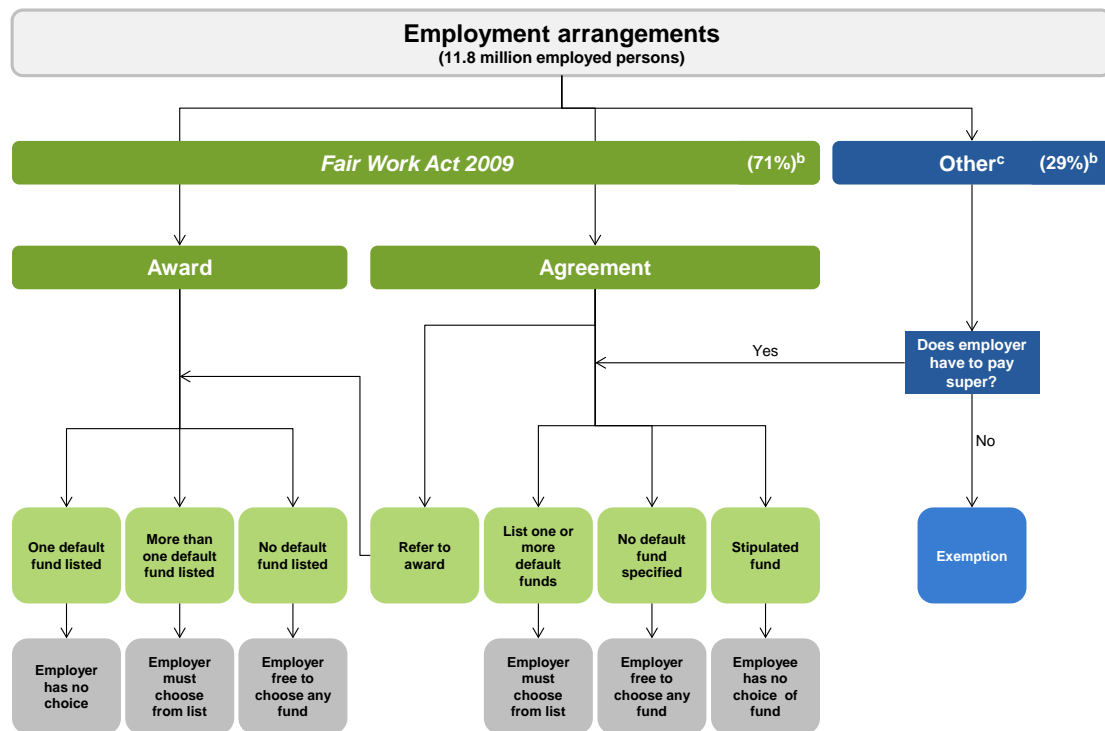
2 Current default arrangements

Default superannuation arrangements in Australia have primarily arisen out of the workplace relations system. This poses a challenge to the inquiry (given its need to consider default selection across the entire superannuation system) as not all employees are covered by the same workplace arrangements. Most employees are employed under the national workplace relations system, via awards or enterprise agreements subject to the *Fair Work Act 2009* (Cwlth). Employees not employed under the national system are generally covered by state-based systems.

Under the *Superannuation Guarantee (Administration) Act 1992* (Cwlth), employers are required (with limited exemptions) to make contributions to their employee's superannuation fund. 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 awards, agreements, contracts and other employment arrangements (figure 2). 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 (box 1).

Estimates of how many employees use default arrangements for their superannuation fund vary. Available evidence suggests it is a considerable number, in the order of two thirds of fund members (PC 2016).

Figure 2 **Default funds in Australia's workplaces^a**



^a Default funds are for employees that do not make an active choice. All default funds must offer a MySuper product or be an Exempt Public Sector Superannuation Scheme. ^b Numbers in brackets are the approximate proportion of total employed persons under the specified work arrangements, sourced from (PC 2015). ^c This includes state-based systems and common law employment contracts.

Box 1 **Introduction of MySuper**

MySuper was introduced in 2013. MySuper products were designed to be simple and cost-effective superannuation products replacing previous default products. The intention was to ensure members do not pay for any unnecessary features they do not need or use. MySuper products have a simple, relatively standard set of product features to enable members, employers and market analysts to compare funds more easily (Shorten 2011). Since 1 January 2014, only MySuper products or Exempt Public Sector Superannuation Schemes have been able to receive default superannuation contributions relating to new employees.

Each superannuation fund is able to offer one MySuper product with a single, diversified investment strategy (which may be a life-cycle strategy) and a standard set of fees available to all prospective members. However, employers are able to negotiate with funds to obtain a discounted administration fee for their employees. Funds also have the flexibility to offer employers with more than 500 employees a specific MySuper product tailored to the needs of a particular workplace. These tailored products may differ from a fund's main MySuper product in terms of investment strategy, member services and fees.

MySuper products are also required to offer a standard level of life and total and permanent disability insurance by default. Members are able to increase or decrease their insurance cover (if offered by the trustee) without having to leave the MySuper product.

Awards

For employees covered by modern awards, employers select a default fund from a list compiled by the Fair Work Commission for that relevant award. The funds currently listed in awards are a result of the award modernisation process undertaken in 2008-09. By and large the funds listed in pre-reform awards were incorporated into the new awards with the consent of industrial parties: employer representative bodies and unions. Legislative changes in 2013 mean that a fund must offer a MySuper product to remain in the award.

Currently, the vast majority of the 122 listed modern awards stipulate one or more default funds from which an employer may select one. Where an award does not list any funds, employers are free to choose any fund with a MySuper product as their default (PC 2012). The Commission has previously reviewed the listing arrangements for default funds in awards and recommended a competitive process (box 2).

Box 2

The Commission's 2012 report on Default Superannuation Funds in Modern Awards

In 2012, the Productivity Commission was tasked with designing criteria for the selection and ongoing assessment of superannuation funds eligible for nomination as default funds in modern awards. The Commission made a number of recommendations aimed at addressing concerns that the selection of default funds had hitherto often been based on precedent rather than merit, and to encourage improved performance and better outcomes for members through increased competition.

In response to the report, the Australian Government in 2013 legislated a new review process for choosing default superannuation funds, but these have not been implemented. As a result, no new funds have been listed in modern awards since then.

Sources: PC (2012); Ross (2014).

Outside awards

Employees not covered by awards are generally subject to either an enterprise agreement or common law employment contract, or fall under a state-based system. Default fund selection under enterprise agreements is similar to that applying to awards, except that some agreements stipulate a specific 'named' fund that all employees covered by the agreement must use.

For employees covered under common law employment contracts, state-based awards, or other arrangements, employers can choose any fund as a default unless a fund is stipulated in the specific employment arrangement. The fund must be licenced by the Australian Prudential Regulation Authority (APRA) and offer a MySuper product.

The rationale for defaults

The concept of defaults (and their presence in workplace instruments) has been integral to the development of Australia's superannuation system, largely stemming from the decision to make superannuation compulsory and the inherent complexity that individuals face in making decisions about retirement incomes. Many employees appear disengaged from the superannuation system or do not feel qualified to choose a fund, and there is recognition that poor choices of superannuation fund could increase future reliance on the Age Pension. Default funds also potentially reduce the cost and complexity for employers of complying with their Superannuation Guarantee obligations. The reliance on default funds in the system also reflects concerns from unions about non-compliance with superannuation obligations by some employers in the absence of relatively straightforward default arrangements.

However, the presence of defaults also has downsides for efficiency and competitiveness.

- Where default products are largely homogenous, they might not meet the needs of members who have diverse characteristics and needs (PC 2012). Further, relying on third parties to make decisions on employees' behalf can lead to principal-agent problems.
- On the demand side, the use of defaults may diminish active participation by members, making them less responsive to price signals and other elements of fund performance. This could lead to the persistence of high fees, low quality products, and the subsequent erosion of member balances over time. On the supply side, regulatory arrangements surrounding default funds create barriers to entry for firms wishing to participate. These could diminish the incentives of default funds to perform well, and exacerbate problems caused by muted demand-side competition.

Some of the original rationales for the current default architecture are no longer as relevant today. The system has matured significantly over the past quarter century, with accompanying improvements in transparency and compliance. Australians are much more familiar with the concept of superannuation and its workings. However, retirement decision making remains very complex.

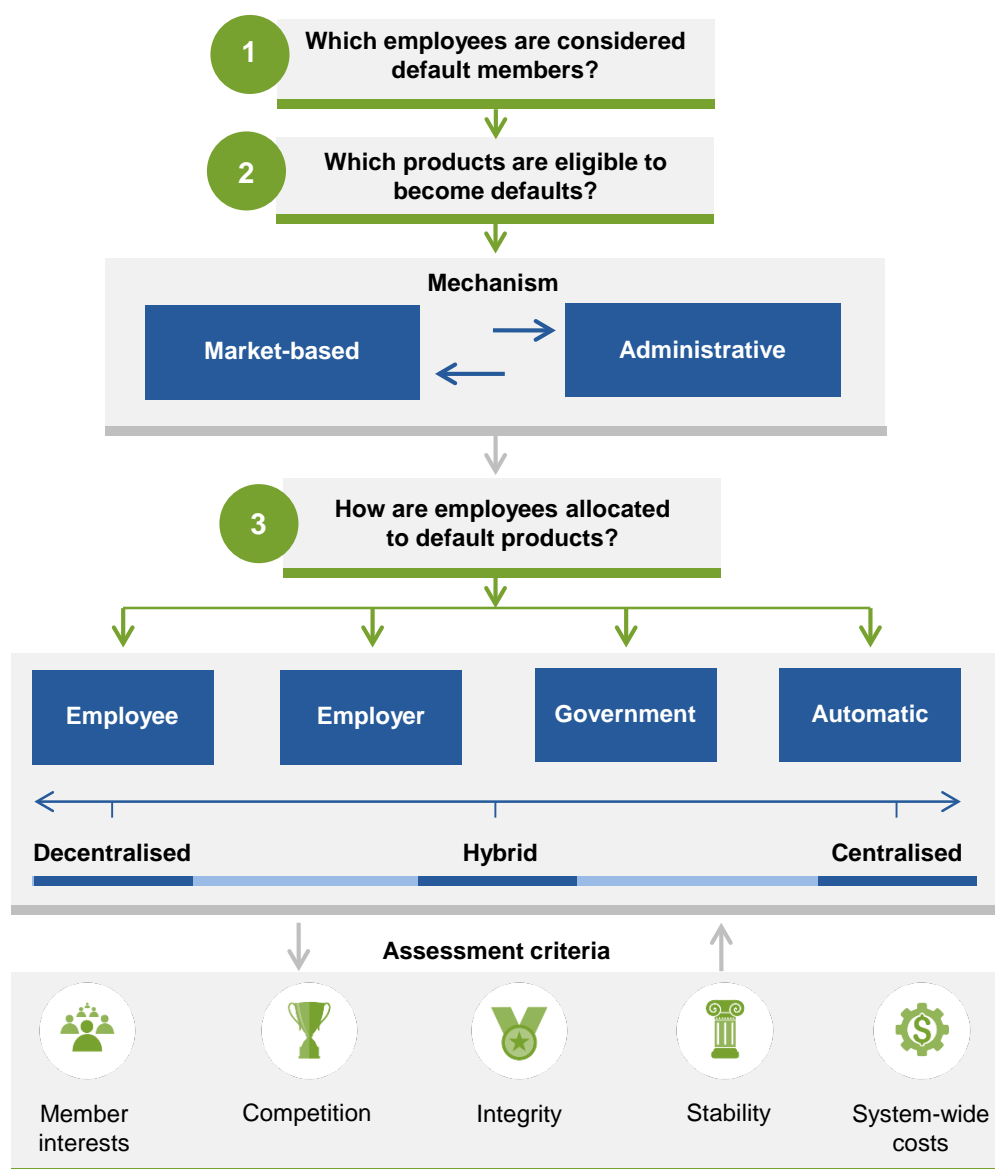
Having no defaults is our preferred, objective baseline for this inquiry. Alternative allocative models would be assessed against this baseline, and their relative performance against the assessment criteria identified below. The current default selection process could also be assessed in a similar way (including compared to this baseline) in stage 3. All alternatives to the baseline could bring potential costs and benefits, and the assessment would need to examine who bears these costs, as well as who reaps the benefits of the alternatives.

3 Developing alternative allocation models

For the purposes of this inquiry, the Commission will be developing models to allocate *default fund members* (employees who do not make an active choice about their superannuation fund) to *default products*. There is no intermediate decision of selecting a default fund.

In developing a set of alternative models, the Commission will use an iterative process: designing specific models, assessing those models against a set of criteria, and then using that assessment to fine-tune the models (figure 3). As such, the assessment framework is embedded in the model development process.

Figure 3 The Commission's process to develop allocation models



Criteria for assessing alternative models

The ultimate objective of default arrangements is to improve the efficiency of the superannuation system and, by extension, the wellbeing of the community as a whole. In developing alternative models, the Commission will be guided by this overarching objective, as well as the detailed principles and considerations set out in the terms of reference. It will also be informed by the criteria for assessing the competitiveness and efficiency of the superannuation system that are being developed as part of the stage 1 study (PC 2016).

The Commission proposes to assess alternative models against five criteria:

- ***members' best interests***: meeting the best interests of members, by maximising long-term net returns and allocating members to products that meet their needs
- ***competition***: fostering competition between funds that drives innovation and cost reductions, facilitates new entrants to the market (contestability) and leads to efficient long-term outcomes
- ***integrity***: minimising scope for the allocation process to be manipulated (or 'gamed'), including by using clear metrics that are difficult to dispute and by holding funds accountable for the outcomes they deliver to members
- ***stability***: supporting a stable superannuation system, including by building trust and confidence in funds regulated by APRA
- ***system-wide costs***: minimising the total costs to members, employers and funds, including costs associated with regulatory compliance, complexity, 'churn' and 'gaming', and minimising costs to government of implementing and administering the models.

The five criteria collectively capture competition and efficiency. These criteria essentially relate to the benefits and costs of each model, and will be assessed from the perspective of the community as a whole. As noted, the Commission proposes to assess benefits and costs relative to a baseline scenario of no default system.

The Commission is also required to have regard to fiscal costs and risks to the Government, including the extent to which a competitive process can reduce reliance on the Age Pension. The main fiscal risk posed by default arrangements is that funds do not maximise net returns for members or, in the extreme, become insolvent. The Commission thus proposes to interpret this part of the terms of reference to mean that the model should deliver competitive returns on members' balances and not create undue systemic risk.

In balancing the criteria above, trade-offs may arise. For example, models that are administratively simple could be lower cost to implement, but they could in some cases be more prone to manipulation. Repeating a process more frequently would increase contestability, but could also reduce stability in the wider market and increase the administrative costs of running the process. Moreover, losing default status could

subsequently affect a fund's viability and lead to increased churn in the system, which may be undesirable.

Finally, the Commission is required to examine any regulatory impediments to optimal competition under each model.

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?

What regulatory impediments to optimal competition might be relevant?

Designing the models

The Commission proposes to use three main steps in designing models:

1. identifying which employees the model would cover
2. specifying a competitive process to determine which products are eligible to be used as defaults
3. specifying how employees would be allocated to eligible default products.

Each step is discussed in greater detail below. A range of considerations will need to be taken into account in applying these steps. At a minimum, the models will need to include a competitive process and be 'workable'. The Commission will also be guided by the assessment criteria set out earlier, which are based on the competition and efficiency principles and considerations set out in the terms of reference. For example, consideration will be given to how feasible each model is, whether it could be subject to manipulation, and what implications it would have for superannuation funds, employers and employees.

A range of sources will inform model design. These include academic and other literature, models used in other countries and sectors, and input from participants in this inquiry. Models used in other countries can highlight key implementation challenges and unforeseen consequences of different approaches (box 3), although lessons need to be drawn carefully given the substantial policy and institutional differences between Australia and other countries. Regulatory structures and commercial practices in other sectors — such as government infrastructure procurement, banking, insurance, telecommunications, electricity or water — may also provide helpful insights, subject to careful interpretation.

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

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

Box 3**Models used in defined-contribution schemes overseas****Chile**

In 2008, the Chilean Government introduced a public tender system designed to increase competition between authorised pension funds and reduce fees. This involves a tender every two years where funds bid on being the default fund for new employees entering the workforce. The fund with the lowest administration fee (which must be lower than the fee in effect at the date of the bidding process) wins the tender and is designated as the default fund. New workers entering the workforce are obliged to join the default fund and remain with it until the end of the fund's 24-month default term. The winning fund must offer the same fee level in its default bid to all of its members, regardless of whether they are existing members or new employees. All employees have the ability to switch from their existing fund to the default fund, and new employees are able to choose another fund at the end of the 24-month period.

New Zealand

KiwiSaver is an opt-out defined contribution scheme. Individuals can choose the rate at which contributions are deducted from their pay. While employees are free to choose their fund (and switch funds at any time), those who do not make a choice are enrolled in their employer's chosen scheme, which must be one of nine default schemes determined through a government tender process. Employees are given three months to choose another scheme before their enrolment in the default is confirmed. The current nine default providers were determined by an expert panel in March 2014 based on criteria such as fees, credibility and organisational and investment capabilities. The maximum number of default funds is pre-determined before the bids are assessed by the panel.

Sweden

Under Sweden's 'premium pension' system, employers contribute 2.5 per cent of wages to each employee's premium pension account. The Swedish Pensions Agency forwards the contributions to the pension fund chosen by each individual employee. Employees who do not choose a fund are allocated to the government-run default fund. Initially, two thirds of people chose a fund other than the default. However, most employees now revert to the default fund, which is seen as low cost, in part due to a relatively passive investment strategy and economies of scale.

United Kingdom

The United Kingdom has automatic enrolment for workplace pension schemes, with members able to opt out within one month and have their contributions refunded. In addition, the UK Government created the National Employment Savings Trust (NEST), a state-owned pension scheme into which workers could be automatically enrolled. Employers can choose private-sector options as long as they are 'as good' for workers. The default option in NEST is a series of Retirement Date Funds, each designed for people withdrawing their money in a particular year (namely, when they reach age 65 or their state pension age). All members, including default members, have the option of switching to other NEST funds or changing the year in which they want to withdraw their money. From April 2017, members will be able to shift freely between NEST funds and other pension funds.

Sources: Mercer and Australian Centre for Financial Studies (2015); Littlewood (2012); Minifie, Cameron and Savage (2014); NEST (2015, 2016); PC (2012); SPA (2015).

Step 1: Identifying employees

The models are required to cover default members across the whole superannuation system. The Commission interprets this to be **the flow of new default members** — that is, employees starting a new job who do not make an active choice about their superannuation fund.

The Financial System Inquiry proposed that funds compete for new default members, with the successful funds required to provide the same product to their existing default members (Murray et al. 2014). Such an approach would not require existing default members to be switched between funds. It would also leave the majority of members of defined benefit funds (which are mostly closed to new members) unaffected.

While it is theoretically possible to have different allocative *models* for different groups of new default members — for example, segmented by occupation, age, or employment arrangement — this appears on first examination to be an unnecessary complication. If different employees have significantly different superannuation needs, these can be accommodated by different products within the same allocative model (see below). However, there may be a case for exempting some new employees from the alternative default models (for example, employees eligible to become members of a defined benefit scheme).

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

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

Step 2: Specifying a competitive process to determine default products

It is also necessary to specify which superannuation products would be eligible to receive default contributions. The Commission proposes to restrict its focus to accumulation products in defined contribution schemes. 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.

A competitive process to determine which products are eligible to be used as defaults would have several components:

- *the mechanism* by which funds compete — this could be administrative (such as a filter), market based (such as a tender or auction), or a combination of the two
- *the metrics* on which funds compete — specific product features, such as fees, ancillary services or past returns
- *the frequency* by which the mechanism is run, and by whom.

Each of these components could involve a higher or lower degree of centralisation, depending on the model. In a highly centralised model, a government body would specify a mechanism and metrics for competitive selection of funds, and then directly allocate employees to the product(s) that are selected.¹ By contrast, in a fully decentralised model, employees would individually choose a superannuation product from the full set available in the market — the competitive mechanism would be akin to that observed in other markets, where firms compete on product features that matter to consumers.

A hybrid model would involve some combination of these approaches. For example, there could be a centralised competitive mechanism for determining a list of products that are eligible to be defaults, with employers or employees then having discretion as to which product from this list to choose.

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

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?

What other considerations are relevant to specifying a competitive process?

Step 3: Allocating employees to eligible default products

The final step is to specify how employees (as identified in the first step) are allocated to eligible default products (as identified in the second step). In a centralised model where only one product is determined to be eligible, the allocation of the defaulting employee would be automatic: all new employees who do not actively choose their own superannuation fund would be assigned to the single default product.

Where multiple products are eligible to be used as defaults, a number of approaches are possible. For example, in a relatively centralised model, a government body would decide which employees are allocated to which product. This might be done randomly, or by segmenting employees (such as by occupation or age), or according to a predetermined formula (with a proportion of employees allocated to each product depending on that product's characteristics). In a more decentralised model, it might be necessary to revert to employer choice among the eligible products, which could introduce an additional layer of competition, but may create other challenges.

¹ In this inquiry, the Commission does not intend to countenance a fully centralised model — in the form of a monopoly government-run default product — because it is not consistent with the requirement in the terms of reference for alternative models to be competitive.

Segmenting employees could allow for ‘smart’ defaults to be developed — that is, default products that reflect the requirements of specific groups of employees. For example, in the UK National Employment Savings Trust, the default option is one of the approximately 50 Retirement Date Funds in place (NEST 2015). However, a high degree of tailoring could come at the risk of making it difficult to compare products or muting competition between funds.

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?

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

4 Some options for an allocation model

The purpose of this section is to present three simple types of models, in order to flesh out potential benefits, costs and institutional considerations that would need to be taken into account in examining each model. This section also flags some of the key evidence gaps associated with understanding the full implications of each model.

The discussion focuses on steps 2 and 3 in the process outlined above: how eligible products would be determined, and how employees would be allocated to products. The set of employees that would be covered by the models (step 1) would need to be identified in advance under any of these models.

Inquiry participants are encouraged to put forward alternative models (which may be combinations or hybrids of the basic models below), or flesh out the more detailed design aspects and implementation challenges each model would entail in practice. The Commission encourages participants to think outside the box.

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

Administrative model

In an administrative model, a government body would use a ‘filter’ to determine which products are eligible to be used as defaults. This filter (the regulatory mechanism) would be akin to a set of minimum standards that products must meet. The filter would not rank the relative performance of products.

An administrative filter would not necessarily be inconsistent with efficiency. Restricting the number of products eligible to receive default contributions could potentially reduce competition, but other considerations need to be taken into account. First, effective competition does not always require a large number of competitors. Second, a filter could potentially enhance efficient competition by improving product comparability, lowering transaction costs and facilitating more active choice. The key undesirable outcome would be creating a lasting barrier to entry to products that could improve outcomes for members, so the period between reviews against the filter would be relevant.

How would eligible products be determined?

There are many forms a filter could take, both in terms of its metrics, and of how prescriptively those metrics are applied. For example, a filter could be linked solely to MySuper authorisation, or it could extend further to incorporate the currently legislated criteria for MySuper products in awards (box 4). Alternatively, new metrics could be designed over time and informed by evidence. A good way to think of a filter is like the Heart Foundation tick of approval.

There could be a case for calibrating the administrative filter to result in a predetermined number of qualifying products. For example, setting a minimum number could address the risk of generating a very small number of eligible products, with adverse consequences for subsequent competition between them. Prescribing a cap on eligible products might reduce the transaction and search costs of subsequent decisions.

A further question is how frequently the filtering process would be run, including the process for removing products from the list, and how often the metrics are reviewed. Greater frequency could improve the flexibility and accuracy of the filter, as well as increase competition and opportunity for new products to qualify. However, this needs to be weighed against higher compliance and administrative costs, reduced certainty for funds and employees, and potentially placing an unhelpful emphasis on short-term performance.

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?

Box 4 **Current criteria for default products in awards**

Following the recommendations from the Commission's 2012 inquiry, the Australian Government introduced a quality filter in the *Fair Work Act 2009* (Cwlth) for products that would be eligible for inclusion as defaults in modern awards (although, as noted earlier, this process has not been implemented). Under section 156F of the Act, the Fair Work Commission is required to compile a 'Default Superannuation List' on the basis of a set of criteria, which include:

- appropriateness of the product's long-term investment return target and risk profile
- the expected ability of the fund to deliver on the product's return target, given its risk profile
- the appropriateness of the fees and costs, given:
 - its stated long-term investment return target and risk profile
 - the quality and timeliness of services provided
- the net returns on contributions invested in the MySuper product
- governance practices, including mechanisms to deal with conflict of interest
- appropriateness of insurance offered in relation to the MySuper product
- quality of advice given to a member
- the administrative efficiency of the superannuation fund.

How would employees be allocated to products?

A single administrative filter could be applied to all new default members or, alternatively, different filters could be used for different segments of employees (section 3).

Employees could be allocated to products using a decentralised or centralised approach. In a decentralised approach, employers would decide which product to select from the list of eligible products. In a centralised approach, a government body would decide which employees are placed into which products — for example, through random allocation or by selecting a separate default product for different segments of employees.

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?

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?

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

Market-based models

A market-based model would involve some form of explicit and formalised process through which products compete to be deemed eligible as defaults: in other words, some form of a tender or reverse auction process. Numerous variations in design have been proposed in the literature and exist in practice. However, at its heart, the market model involves superannuation funds bidding for the right to receive contributions from default members.

The crux of a market model is the *ex ante* rules of the game: what funds bid for and how the winner will be decided. There is no silver bullet to designing a competitive market model, but key ingredients are attracting bidders, eliciting truthful bids, and minimising scope for collusion and predatory behaviour (Klemperer 2002).

Market models are generally more efficient than administrative allocation models, even in the presence of market imperfections (KVA 2007), and they can reveal the relative performance of products. Repeating the process over time can facilitate ongoing innovation and cost reductions — and thus improve efficiency — as funds benchmark themselves against winning products.

How would eligible products be determined?

A tender mechanism would involve funds submitting bids to a government body, which would then assess those bids and select the best products. These products would remain eligible to receive default contributions for a set period of time, provided that funds continue to meet the commitments they made in their bids.

The metrics used in the tender process could be specified to varying degrees of complexity. The simplest approach would be to run a tender based solely on fees (also known as a reverse fee auction). This would be objective and transparent, and might be lower cost to run, implement and monitor than more complex sets of metrics. A fee-based tender could be focused on administration fees, investment fees or both. For example, the Chilean Government tenders for the right of default fund status based on administration fees (box 3).

However, a tender based solely on fees could also present problems. There is a risk that funds would only offer overly conservative investment strategies and poor quality services in order to lower costs and therefore fees. There may also be the risk that funds would bid fees below costs, venturing that increased scale from default status will eventually offset earlier losses — which could reduce competition in the long-term if other funds are unable to compete or, at an extreme, compromise systemic stability. The tendering process used in Chile has been criticised on these grounds (Chant West 2014), though there may be scope to mitigate some of these problems by stipulating asset allocation ranges or requiring that funds disclose their true costs as a condition of participating in the tender (Minifie, Cameron and Savage 2014).

The alternative is to incorporate multiple metrics in the tender, as is the case in New Zealand (box 3). These could include historical net returns, fees, investment strategy, governance, service quality or other metrics that are typically included in corporate superannuation tenders (PC 2016).

While the use of multiple metrics may avoid many of the problems with a single fee-based metric, it would be challenging to implement. A rigorous and transparent process would be needed to make trade-offs between the metrics, since it is unlikely that one bid would outperform all others on all metrics. This might entail some degree of judgment, especially where metrics are qualitative and difficult to measure objectively. Further, the process would likely be more costly and complex for participating funds, as well as for the government body that administers it and enforces the outcomes.

Under either approach, a key consideration is how frequently the process is repeated. If the process is run too frequently, participation may be less attractive to funds (by not sufficiently rewarding the best performance), which may not encourage innovation and long-term efficiency. However, if the process is run too infrequently, the costs of a poor selection may be amplified. Large periods between tenders could also act as barriers to innovation or to new funds or products entering the market.

Another consideration is how to minimise scope for the tender process to be gamed. There is a substantial economic literature on how firms in other sectors have manipulated government tender and auction processes, either for a direct financial benefit or to reduce competition (Chan, Laplagne and Appels 2003). As suggested in the terms of reference, the Commission will draw on the field of competitive market design. This growing field of economic research utilises theory alongside empirical and experimental evidence to develop allocative mechanisms. Broadly, the approach is to use the key lessons to design market rules that minimise the potential for gaming and collusion (Gans 2010).

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?

How would employees be allocated to products?

As with regulatory models, a single tender could be applied to all new default fund members or, alternatively, separate tenders could be used for different segments of employees. Similarly, employees could be allocated to products using a decentralised approach (where employers or employees select an individual product from a list of winners), or in a more centralised way.

In a centralised approach, the allocation would be automatic if the tender process resulted in a single eligible product (winner). Alternatively, if there were multiple successful products, each could be allocated some proportion of employees — for example, an equal distribution, or weighted by how products ranked in the tender process.

It may also be possible to combine a tender with an administrative filter. For example, only products that meet a minimum set of requirements may be able to participate in the tender. These requirements could be based on current MySuper rules or some other filter.

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?

Active choice by employees

The baseline to be used in this inquiry is that there is no default system at all. After nearly 25 years' experience, it could be even argued that this itself be a new allocation model, where employees themselves must make an active choice of superannuation product. This would remove the employer's responsibility for choosing a default fund and place the onus on the employee, who may be better placed to make a decision in his or her own best interests. However, research on an active choice model (without defaults) is scarce. Most countries that have employer-funded superannuation also have some variant of a default option.

In practice, new employees could be required to nominate a superannuation fund when their employment commences, prior to any contributions being made. This would mirror the current process whereby employees are required to choose their own bank and provide bank account details to their employer for wages to be paid into. The superannuation fund

could remain responsible for directing those contributions to a MySuper product within the fund (unless the member chooses otherwise). The private sector could continue to provide advice and ratings to consumers to help them to understand the features of competing products and make comparisons.

The active choice model could deliver several benefits, such as increased member engagement, fewer principal–agent relationships, greater supply-side competition and reduced burdens on some employers. By getting each employee to directly choose the product that best accords with their preferences, it would facilitate competition on both price and product features. It would also likely be cheaper than (intermediated) default selection processes, and less conflicted.

However, the model could also impose significant costs. For example, behavioural finance research suggests that increased member engagement may not necessarily lead to better outcomes. Choosing the most suitable product from the thousands available can be a daunting task for members. Further, superannuation funds could choose to compete on product features that are not in members’ best interests (PC 2016) (though there is nothing to prevent this happening now). Implementing an active choice model also has practical challenges and new processes may be needed to ameliorate some of the costs. For example, there may need to be limits on the types of inducements superannuation funds can provide to employees.

Active choice with filter

An active choice model need not be completely decentralised. A filter or a market-based mechanism could be used to narrow choices or ‘nudge’ members to high-performing funds (box 5). For example, the active choice model could operate in concert with some filter to determine a shortlist of superannuation products recommended to new employees (with employees allowed to choose products not on this list should they wish). This form of ‘nudge’ could reduce search costs and mitigate the impact of behavioural constraints on the decision.

Government may design and apply this filter. Alternatively, government may only establish the filter architecture, with the actual analysis and application done by the private sector. The private sector already publishes similar lists of superannuation funds. Comparison tools — such as those available for electricity contracts and insurance — could also reduce search costs.

Box 5 **Behavioural finance and nudges**

Behavioural finance can be used to understand the different behavioural biases that impede decision making. Internationally, there is a large and growing body of experimental evidence on the heuristics people use to make retirement savings decisions and the biases that these can introduce, such as status quo, framing and familiarity bias.

Further, behavioural finance provides insights about how even small changes to the framing of a decision, the reference point used, or the way information is provided can lead to significant behavioural changes. For example, when comparing two superannuation products with different levels of investment risk, consumers are likely to react differently if the risk is framed positively (expected returns) or negatively (probability of a negative return). These behavioural modification tools, collectively known as ‘nudges’, can be used to improve decision making by passively nudging individuals towards a decision.

Nudges and other lessons from behavioural finance could help address some of the difficulties of financial decision making by individuals in an active choice model.

Sources: Levin, Schneider and Gaeth (1998); PC (2016).

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?

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Attachment A: How to make a submission

How to prepare a submission

Submissions may range from a short letter outlining your views on a particular topic to a much more substantial document covering a range of issues. Where possible, you should provide evidence, such as relevant data and documentation, to support your views.

Generally

- Each submission, except for any attachment supplied in confidence, will be published on the Commission's website shortly after receipt, and will remain there indefinitely as a public document.
- The Commission reserves the right to not publish material on its website that is offensive, potentially defamatory, or clearly out of scope for the inquiry or study in question.

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- Copyright in submissions sent to the Commission resides with the author(s), not with the Commission.
- Do not send us material for which you are not the copyright owner — such as newspaper articles — you should just reference or link to this material in your submission.

In confidence material

- This is a public review and all submissions should be provided as public documents that can be placed on the Commission's website for others to read and comment on. However, information which is of a confidential nature or which is submitted in confidence can be treated as such by the Commission, provided the cause for such treatment is shown.
- The Commission may also request a non-confidential summary of the confidential material it is given, or the reasons why a summary cannot be provided.
- Material supplied in confidence should be clearly marked 'IN CONFIDENCE' and be in a separate attachment to non-confidential material.
- You are encouraged to contact the Commission for further information and advice before submitting such material.

Privacy

- For privacy reasons, all **personal** details (e.g. home and email address, signatures, phone, mobile and fax numbers) will be removed before they are published on the website. Please do not provide a these details unless necessary.
- You may wish to remain anonymous or use a pseudonym. Please note that, if you choose to remain anonymous or use a pseudonym, the Commission may place less weight on your submission.

Technical tips

- The Commission prefers to receive submissions as Microsoft Word (.docx) files. PDF files are acceptable if produced from a Word document or similar text based software. You may wish to research the Internet on how to make your documents more accessible or for the more technical, follow advice from Web Content Accessibility Guidelines (WCAG) 2.0<<http://www.w3.org/TR/WCAG20/>>.
- Do not send password protected files.
- Track changes, editing marks, hidden text and internal links should be removed from submissions.
- To minimise linking problems, type the full web address (for example, <http://www.referred-website.com/folder/file-name.html>).

How to lodge a submission

Submissions should be lodged using the online form on the Commission's website. Submissions lodged by post should be accompanied by a submission cover sheet.

Online* <http://www.pc.gov.au/inquiries/current/superannuation/alternative-default-models>

Post* Superannuation
Productivity Commission
Locked Bag 2, Collins St East
Melbourne VIC 8003

* If you do not receive notification of receipt of your submission to the Commission, please contact the Administrative Officer.

Due date for submissions

Please send submissions to the Commission by **28 October 2016**.