PRODUCTIVITY COMMISSION – SUPERANNUATION: ALTERNATIVE DEFAULT MODELS

SUBMISSION

October 2016

The Association of Superannuation Funds of Australia

Introduction

ASFA welcomes the opportunity to review the Productivity Commission's *Superannuation: Alternative Default Models* issues paper and provide this submission. In drafting this submission, ASFA consulted with, and sought input from, its membership.

ASFA's approach

In the issues paper, the Productivity Commission has assumed a scenario of 'no defaults' as the baseline for comparing alternative models. ASFA's view is that a more appropriate approach is to consider alternative models within the context of the existing system and the insights of behavioural economics.

In considering whether the benefit of a new default model outweighs the cost, there are a range of criteria to evaluate its effectiveness. Competition is not an end it itself but can be a means to potentially provide better outcomes for members. Greater competition needs to be taken into account as part of a broader set of factors that will determine outcomes for members which include:

- Existing and past policy settings and how they have created the current structure;
- A transition path from the existing settings and the viability of the new model in light of this;
- The impact of consumer behaviour on outcomes including taking into account developments in behavioural economics; and
- The efficiency of the superannuation system, which has competition as just one sub category of issues.

Superannuation and group life insurance touch the lives of almost every Australian. Superannuation is the second largest financial asset for most Australians and the magnitude of the importance of superannuation for individuals warrants careful consideration of the impact of changing from one policy setting to another. The potential risks include the impact on the financial stability of individuals, the superannuation system and to the long term sustainability of the Commonwealth Budget.

While it is true that there would be less need for defaults if individuals were fully engaged and had sufficient financial literacy to make active choices in superannuation, many people do not have this capacity or do not want to be engaged. While we should aspire for greater financial literacy and the government and industry should actively pursue this as a goal, we also agree with the conclusions of the Super System Review that default arrangements are a necessary part of superannuation for the foreseeable future. Based on the analysis and recommendations of the Super System Review, MySuper was specifically developed to deal with a lack of engagement by consumers. The superannuation industry has recently implemented MySuper reforms to specifically provide for defaults to implement the Stronger Super reforms.

The critical role that an employer plays in calculating and remitting contributions based on the superannuation fund nominated or default arrangements also needs to be taken into account. It is also important to recognise that competition is not an end in itself or a corollary of efficient markets. Better outcomes for members as a result of greater competition should be considered the goal the system strives for. For all of these models ASFA believes the provisions around best interest of members need to be maintained and is a key requirement of any default model.

ASFA has evaluated the alternative default models proposed in the issues paper, taking into account the current structure of the superannuation system including the inherent need for default arrangements and the impact a model would have on consumers. We have also considered the path required to bring such a model into effect.

Factors that may meet the needs of one cohort of default members may not be appropriate for another. The idea of a sound default offering should not be conflated with a one size fits all approach to product design.

Taking these factors into account, ASFA outlines the pros and cons of each of the models proposed in the issues paper.

The auction or tender model

While there are pros and cons for each model, ASFA has a particular concern with the proposed auction or tender model. Depending on design, this model can adversely impact on member benefits and retirement outcomes as well as industry stability.

While a system-wide auction or tender model has the potential to bring more market forces to bear on default allocation, ASFA considers that the risks and potential costs of this model far outweigh these potential benefits. Some of the most significant potential negative outcomes are:

- Funds responding to the tender by loss leading in an attempt to grow market share (and adjusting their fees upward later);
- Difficulties in establishing objective and quantifiable criteria to evaluate the bids for factors like levels of service;
- Price (in the form of administration and investment management fees) becoming the dominant determinant of the winning bids. This could result in a race to the bottom in terms of service levels, net investment returns and development/ maintenance of administrative and other systems;
- A focus on price/fees leading to the development of passively managed products with a heavy investment weighting towards bonds;
- Members of funds that lose multiple tender rounds could be stranded in funds that are potentially sub-scale in the absence of long-term default fund flows;
- Costs of tendering are likely to increase the costs of the system;
- Difficulties for new entrants to compete once a limited number of default funds are entrenched;
- It is difficult to build in the concept of innovation into the tender, which when coupled with a focus on price, will drive the system towards homogeneity; and
- Impact on the stability of the system due to a limited number of winning bids.

The risks and costs arising from this model, particularly in the context of transitioning from the existing model are significant. ASFA's view is that this model should not be given further consideration.

Insurance

The group life insurance market in Australia has the attributes of a competitive market and is responding to the needs of superannuation fund members. Insurance firms compete to win group insurance of superannuation funds where they effectively already respond for requests for tender. Trustees of superannuation funds chose the insurance fund that provides the best price and features that fits the demographics of their superannuation fund. A default insurance product separate to the default superannuation fund would prevent trustees from choosing an insurance product that best fits their members. Also, insurance providers can currently tailor their product to meet the demographics of the superannuation fund they service. A separate default insurance product servicing many different superannuation funds would mean the demographics of the pool would be highly diverse and therefore more difficult to price. It would also lead to the loss of economies of scope in that there would be separate and additional administration costs associated with the insurance cover. An appropriate analogy is that it is much more expensive to assemble a car from tenders for spare parts rather than buying it as one complete package.

Some options for an allocation model

Administrative model - Part 1 (the model)

Observations

In addressing this model we have assumed that the products under consideration would, as a minimum, be MySuper products.

If additional filters were to be applied, such as the currently legislated criteria for MySuper products in awards, consideration would need to be given as to how to assess new entrants into the market. To maintain competitive tension in the long run, it would be necessary for the process to allow new entrants.

One consideration is the ease of operation of the administrative model. The simplest possible version of a government body using a 'filter' to determine which products are eligible to be used as defaults would be for objective, independently verifiable, criterion/criteria to be specified to act as a 'filter'. A government body could list those MySuper products which meet the criteria. Consideration would need to be given as to how to 'filter' new entrants without any history.

This could be a simple filter using one or a small number of criteria. A more complex administrative filter would necessitate a government body applying a range of quality filters, such as an assessment of:

- The governance and risk management culture and settings of the fund;
- The services provided to members and employers by the fund;
- The offering of a post retirement income stream products by the fund;
- The administrative efficiency of the fund;
- The effectiveness of the complaints-handling of the fund;
- Appropriate of insurance offering;
- Error rates and the efficiency of their resolution; and
- Online/electronic/digital capability of the fund.

Whether or not an administrative filter would have an effect on efficiency would depend on how the administrative filters were designed and implemented.

Greater frequency of running the filtering process could improve the flexibility and accuracy of the filter, as well as increasing competition and the opportunity for new products to qualify. However, this would need 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.

Pros

An administrative model, whereby a 'filter' is utilised to determine which MySuper products are eligible to be used as defaults for employees starting a new job (who have not exercised choice of fund), would ensure that default MySuper products meet a minimum set of standards over and above the regulatory requirements with which current default products must comply.

An administrative filter such as risk-adjusted net returns could contribute to supply-side competition within the industry, in that trustees of superannuation funds would endeavour to meet the minimum standard in order to be a default MySuper product. This is on the proviso that the number of default MySuper products is not reduced to too few products.

A more complex administrative filter could be implemented which would largely draw upon existing regulatory requirements and frameworks in place, with 'filters' which would focus on and reflect the objective of superannuation. The filters should reflect and encourage behaviours that would produce a more efficient, robust and sustainable superannuation system.

A model that reduces the number of MySuper products which are eligible to be selected as a default fund would assist employers in the selection of their 'default' arrangement.

Cons

Restricting the number of MySuper products eligible to receive default contributions potentially could reduce competition unduly, depending on the filters selected. Consideration would need to be given to market concentration and the extent to which genuine competition among the various players is affected.

Filters could create incentives for trustees to focus on particular aspects of their fund's performance in order to meet the filters, which may not be in the best interests of some or all of their members. This is especially the case over the longer term, where achievement of short-term goals/indicators may be achieved at the expense of medium to longer term considerations, including product innovation.

The default fund mechanism only applies when a new employee does not exercise choice of fund when commencing employment.

Filters could create a lasting barrier to entry for products that potentially could improve outcomes for members. Accordingly, in determining the period between reviews against the filter, this would need to be taken into consideration, along with other barriers such as incumbents' scale, performance history and brand familiarity

Calibrating the administrative filter to result in a predetermined number of qualifying products potentially would lead to serious adverse consequences for fund members, especially if the number was set too low. This could result in inappropriate market concentration, with corresponding adverse consequences upon competition between providers. It also could create considerable disruption to existing providers in the market and ultimately on members.

There is a risk that if the range of filters employed was specified too narrowly they may not acknowledge arrangements that have been tailored for specific industries, workplace, demographics or other characteristics of the membership of particular funds or segments of the market. These arrangements can meet the particular needs of members and/or employers through tailored product design or servicing.

It also needs to be acknowledged that not all MySupers are public offer and there would need to be consideration of what happens to corporate MySupers that are currently non-public offer. Corporate superannuation funds are able to tailor their default product to the demographics of their employees which allows for a product that allows for a better fit with their workforce. If they were unable to continue to provide a default product for their employees then there would be a loss of specificity and a product that is less relevant to these employees.

Administrative Model – Part 2 (the allocation mechanism)

An Administrative Model would require a mechanism to allocate employees who do not choose their superannuation fund (default fund members) to default products.

In its draft framework the Commission presents options for the allocation mechanism, which are distinguished by the degree of centralisation/decentralisation. In a relatively centralised mechanism, a government body (the regulator) would allocate members to products. This could be automatic, where members are allocated randomly to an eligible product. Alternatively, the regulator could allocate members to specific products based on particular characteristics. In a decentralised mechanism, each employer would choose a single default product (from a common list of eligible products) for its employees. The Commission's draft framework allows for hybrid mechanisms.

A crucial design consideration is the role of the product filter. Broadly speaking, the greater the degree of centralisation, the more vital the role of the product filter in determining member outcomes. This is because market pressure among funds – as a driver of member/system outcomes – would tend to be less prevalent in centralised mechanisms compared to decentralised mechanisms.

There are few examples of administrative mechanisms in other jurisdictions (there are, however, several examples of tender-style mechanisms). Sweden and the UK have highly centralised administrative models, where default members are allocated to a single state-owned default fund/scheme. As the Commission notes in its Issues Paper, it has not considered this type of model in its framework.[1]

Government Allocation – random allocation

In this relatively centralised mechanism members could be allocated randomly to a product from the common list of eligible products (the outcome of the product filter).

Pros

Considered in isolation, a mechanism that allocates members to products on a random basis would have low administrative costs for the regulator, funds, employers and members. However, there would be other costs – which are discussed in the next section.

Depending on the allocation mechanism, the administrative burden for employers could be confined to reporting a new employee to the regulator. If this were not the case, the employer would need to be

[1] *PC Issues Paper*, page 11.

notified of the selected fund to contribute to for each and every new employee. If this was not immediately notified, this creates inefficiencies for the employer and employee and risks SG non-compliance. This would need to be streamlined and would require system changes to ensure SG obligations are met. For Government, such a mechanism would have low administrative costs compared with other potential centralised mechanisms – for example, where a government body allocates members to particular products (next section).

That said, government administrative costs associated with a random allocation mechanism would likely differ according to whom random allocation would apply. If the broader default framework applied to new entrants to the workforce *and* current workforce participants that start a new job, a key consideration would be whether the latter would be subject to ongoing random allocation – i.e. once in the system, would a job change trigger a fund reallocation or would the worker retain his/her initial default allocation? A mechanism with ongoing reallocations for job changes would have greater government administrative costs and potentially reduce members' knowledge of and engagement with their superannuation accounts, especially while they had low balances

Cons

A random allocation process would still require a robust and transparent methodology to assess, select, allocate and monitor the performance of default funds.

Performance incentives for funds would need to be built into a random allocation mechanism, since such a mechanism (on its own) could limit competition within the default market.[2] However, getting the incentives right would be difficult, and there would be risks associated with having a regime that is either too weak or too strong.

For incumbent funds, a key performance incentive would be the threat of having their closed to new entrants. The degree of this threat would depend on the degree to which the performance criteria are prescriptive and enforceable, and the enforcement approach of the regulator (see section on *Product Filter*).

A weak regime could mean a lack of competitive pressure among incumbent funds. This could have deleterious consequences for member/system outcomes. Depending on the specific weak points in the performance criteria/enforcement approach, this could affect net returns to members, the quality of member servicing and product/service innovation.

A strong regime would increase pressure on incumbent funds, but also could have unintended consequences for system stability and cost. As noted in the previous section on the *Product Filter*, an additional concern is that poorly-designed criteria could distort fund behaviour and result in perverse member/system outcomes.

A strong regime could lead to considerable fund/product churn, where 'under-performing' products are regularly closed to new entrants and replaced. It is likely that this would increase uncertainty among members about the security of their superannuation (if/when their fund/product is closed to new entrants), and could reduce public trust in the broader superannuation system.

[2] There would still be competition among funds to move people from default to choice products.

Higher rates of product churn would increase system-wide costs on all parties in the system (including the regulator), which ultimately would be borne by members as lower net returns (or lower net benefit). Costs of product churn would include costs for funds of complying with product requirements (for new products entering the system), and costs for the regulator of vetting new funds/products.

A relatively strong regime also would require more regular assessment of incumbent product performance. This would increase administrative costs for the regulator, and compliance costs for funds.

Government or regulator allocation would require considerable resources and may result in confusion, bias or conflicts regarding the role of the government in setting policy or the regulator in supervising the financial services industry. An independent statutory body may be more suitable than a government or regulatory body to oversee the allocation model.

Government Allocation – based on member characteristics

The Commission's issues paper includes an option where government could allocate default members to specific products based on particular characteristics – such as age, occupation or type of employment arrangement.

Pros

With respect to the chosen characteristic, this allocation mechanism would comprise a range of products that are tailored to specific cohorts. This could include, for example, products that differ with respect to asset allocation/risk profile. Considered in isolation, more tailored products would lead to better member outcomes, provided that the tailoring is actually relevant to the needs and circumstances of the members concerned.

The positive aspects of segmenting by industry or occupation include being able to match investment profile and insurance product design to member occupation. For example, workers whose occupations lead to shorter working lives need high growth asset profiles at younger ages, and insurance design that recognises their work profile.

Cons

There are trade-offs with respect to the degree of granularity of cohort products, and it would be difficult to get the balance right.

By construction, tailored products for each cohort, based on a set of assumptions, would be tailored for the 'average' individual in each cohort, not to the range of individuals. This means that not all members would be allocated to the product that bests suits their circumstances. To take age as an example, not all individuals in a particular age cohort have the same asset allocation/risk profile preferences. Individuals have very different life and career paths which will not always meet the average. They also will have different levels of assets held outside of superannuation. The prospect of different defaults for different age groups also raises the question of the demand from funds to provide these services. For example, a default product for older, lower balance demographics may not be desirable for superannuation funds and it may be difficult to get a fund to provide such a product (in contrast, funds with older, higher balance members may not suffer from compounding effects of net outflows and will be highly contested by funds).

Finer granularity might allow for more precise tailoring, but would increase costs in the system. For funds, finer granularity would mean a larger number of products to design and more extensive compliance obligations. There also would be a need to collect additional information about and/or from fund members. In addition, greater disclosure and communication would need to be made, to ensure tailored products remain appropriate and keep pace with changes in an individual members' circumstances. For the regulator, finer granularity would mean more product vetting and more performance monitoring. Overall, the finer the degree of granularity, the greater the system costs.

Additional problems relate to the costs and risks associated with product switching. Finer granularity would mean more (automatic) switching of members' accounts between cohort products. This would result in larger administrative costs for the regulator, but also a greater risk that members become 'lost' when switched between products. For funds, this will result in uncertainty regarding cash flows, may reduce the level of liquidity and may result in more conservative, sub-optimal investment decisions.

At a broader level, this mechanism would pose risks to public trust in the (new) default system. This mechanism entails an explicit role for Government in determining which product is best suited for a particular person. If the default system produces returns that are below members' expectations, then members' concerns about their funds' performance could see a broad erosion of trust in the (new) default system and government's role in it. While sequencing risk (that is, the risk of being in an inappropriate asset allocation at a certain point in one's savings experience) affects every superannuation fund member, a government mandated allocation could make the government responsible for any negative outcomes from defaulting into one asset allocation or another. The government should not be deciding which products would be best suited for particular individuals (or cohorts).

Employer Choice

At the decentralised end of the spectrum, the Commission's draft framework includes an option where each employer would choose a single default product for its employees from the common list of eligible products.

Pros

Employers, by choosing products, could contribute to competitive pressure in the system potentially leading to better outcomes from members. Some larger employers have a view that superannuation is a workplace benefit and are committed to superannuation on that basis. That said, not all employers would be sufficiently engaged to make a considered decision.

For regulators, administrative costs with respect to allocation of members would be low. The main costs would be associated with collecting, recording and managing information from employers on default product choice but could be managed through Super stream reporting.

Cons

As noted above, not all employers would be engaged to make a considered decision on choice of funds. In such cases, employers' choice of default product would effectively amount to a random allocation – as per the Government Allocation mechanism.[3] However, for effectively the same outcome, it's likely that system costs would be higher than for the centralised random allocation mechanism, as funds would compete more vigorously to attract employers increasing marketing and advertising costs.

It is clear that many employers do not wish to have the burden of determining an appropriate default fund for their employees as this may expose employers to liability in the event the fund does not meet employees' needs.

For employers that chose a fund, this would impose costs on those employers. This would include the time taken to consider the eligible products via a tender process and select a default product, and the administrative cost of processing the choice and supplying the information to the regulator. This would be alleviated to some extent by single touch payroll.

[3] Employers will use heuristics and short hand selection methods such as brands, familiarity (banking relationship)

Market based mechanism based on a tender

A tender model for allocating rights to the default members would require an organisation run the tender to decide a limited number of funds to receive default funds. The Productivity Commission has proposed that the organisation be a government body. The Commission also has outlined a number of possible options for such an approach. Broadly these are:

- A tender based solely on fees; and
- A tender based on a broader range of criteria.

It has also proposed that there would either be a limited number of funds selected from the tender, a single fund or different funds for different market segments.

There are few examples of tender based models. In Chile the government runs a tender every two years with the fund that has the lowest administrative fee winning the tender.

Pros

A tender system has the capacity to bring market forces more to bear on the default selection process. Currently members who default do not make an individual decision based on price and quality. A tender based on criteria that included specific criteria could bring price and quality into the decision over and above the current mechanism for setting defaults. By using criteria to select funds based on price and quality criteria, the tender process can replicate a market to some extent. Superannuation funds would then compete directly to win the tender.

Such a system could drive down the cost of managing default superannuation. Assuming fees was included as one of the elements to be considered by the tender process funds, it is one of the areas in which there could be the clearest and simplest comparisons between funds (despite variations between the way funds report). This would particularly be the case if fees were the only criteria considered. If other criteria were used the impact on price of the tender process would in part be dependent on the weighting given to cost in the tender review.

Lower prices would be compounded over time if the tender process were repeated as funds competed on fees in their responses and over time, assuming a limited number of funds were listed as default, their FUM would grow, potentially providing greater scale economies and reducing cost.

To ensure there was an appropriate level of oversight and probity, there may be a need for an independent external panel to be involved in reviewing the tenders as the outcome has such a significant impact on superannuation fund members and organisations.

The Australian government has run tender processes for large expenditure regularly for projects such as defence procurement and job network. Although they are not free from criticism, the techniques for such projects could be utilised as a template.

Several separate tenders could be run to provide default products for different demographics or types of employees. This could provide default products that are targeted at the existing needs of employees in certain demographic or employment categories.

Cons

There is a risk that a tender process would be gamed by superannuation funds. Funds may loss lead with their bid in an attempt to gain default members with a view to upselling a higher cost service at a later date. While this may drive reductions in cost in the short run, it would create a systemic risk and may not be in the members' best interest. If funds were unable to make good on the strategy to up-sell and a successful business was dependent on this then there is a risk the fund may fail to be able to cover its costs as the default segment of their book runs at a loss.

A focus on price could also drive down service levels in the default segment. In an effort to reduce costs, fund providers may seek to compromise the control environment, reducing the level of staff in critical areas such as compliance and risk management and not investing in quality controls. From an operational risk perspective, this would drive short-termism, which would impact on investment in the system.

Regardless of other criteria included in the RFT, there is a risk that price would become the dominant factor as it is probably the simplest and most easily quantifiable comparator. This could lead to a "race to the bottom" in terms of service for members.[4] MySuper products include a range of member benefits such as, income stream offerings, advice, and website functionality. To reduce costs to a minimum, all non-core services for members such as these, may be reduced or dropped altogether. In addition, it is also very difficult to build concepts like innovation into a tender process. This combined with a focus on price would restrict innovation in the sector. It would also drive homogeneity in default funds.

A focus on costs and fees, rather than net member benefit, would be likely to lead to development of passively managed products with a heavy investment weighting toward bonds. This is not, in ASFA's view, an approach that will maximise long-term investment returns and deliver the most benefit for fund members.

There would also be an incentive for funds to respond specifically to the RFT criteria and not go beyond these. The focus of the tender response for funds would become meeting these criteria alone and not producing innovative products, enhancing servicing models or maintaining appropriate quality controls.

A limited number of generic default super funds would exclude funds from specifically creating niche products to meet particular default fund markets. There may be some industries which have specific characteristics that can be met by the existing default fund as that fund was created to service that particular type of employee or demographic. Such specific characteristics could not be provided in a generic default product designed for people from many different and heterogeneous industries.

A tender which restricted the number of default funds could have a significant impact on the stability of the superannuation system in a number of ways if a limited number of default funds were selected.

First, at the initial allocation of default provision, default members of superannuation funds could be left stranded with funds that are small in scale that had hitherto been receiving default contributions.

Second, this upheaval would be ongoing and compounded over time when the tender process was repeated. Superannuation funds would shift in and out of the system with default contributions flowing and then halting or vice versa. This would have a substantial impact on business models and more

[4] While there is considerable complexity in measurement and comparison of fees, as a factor that can be actually be quantified in a single number it is more comparable than other factors such as ;levels of service or returns which are even more difficult to quantify and compare.

importantly the members of funds that remain in default funds no longer receiving default contributions. There would be little incentive for funds to maintain the level of service provided to members of their legacy default product.

Third, a system where default contributions flow to a small number of funds could provide a barrier to entry for new entrants. Ease of exit and entry is a fundamental necessary aspect of a competitive market which can drive greater efficiency and better member outcomes. With a few large funds taking all of default contributions, it would be difficult for an existing or new funds to compete in the next tender round due to economies of scale that would accrue to existing players.

A fourth factor would be the uncertainty of cash flows impacting on liquidity considerations.

Each of these four factors would be significantly multiplied if only one of fund was selected as the default fund for all employees.

As with the administrative selection process discussed in section 1, there would need to be a body designated to make the decision on winners of the tender. Superannuation and funds management are complex industries and there are few individuals who understand these complexities who are not conflicted through existing business relationships. Finding individuals with the depth of skill to undertake the tender review and selection process may prove difficult.

If a government agency ran a tender process it would need to be resourced to undertake that task and formal structure within the organisation would need to be established. This would add to the costs of operating the system. If the tender process were itself outsourced to a third party, the operation of the two part tender process would also add to cost. The tender process itself would add to the cost of the superannuation system overall. Tenders for large government procurements have large up-front costs. This will be compounded for funds that aren’t successful as they would incur the cost of the tender without the revenue that would flow from winning default contributions.

The Chile Model in the Australian Context

Leaving aside concerns with rates of return and system risks and focusing on fees alone, it is unlikely that the default fund auction model adopted in Chile would deliver the same apparent levels of success in reducing fees if replicated in the Australian.

- Chile has only a relatively small number of funds, lending feasibility to a tender process. In contrast, Australia currently has just over 250 APRA-regulated funds and around 115 MySuper products on offer.
- The Chilean funds do not offer the range and complexity of services provided by Australian funds, including insurance. Adoption of the Chilean model in Australia would be likely to result in a significant reduction in the services and benefits offered to members.
- A major driver behind the Chilean model was the need to reduce excessively high administration fees, which were inflated by large marketing cost components. The Productivity Commission has noted that between 1992 and 1998, the average marketing cost for the Chilean authorised pension funds ranged between 21 and 52 per cent of total expenses.[5]
- There is no evidence to suggest that marketing costs incurred by Australian default funds have approached these levels or are likely to do so caution should be exercised if seeking to attribute cost reductions in the Chilean system solely to the introduction of the default fund auction model. Rather, they can, in part, also be attributed to other recent reforms such as restricting the frequency with which individuals can switch between funds, regulation of the use of sales agents, along with a reduction in competitive forces due to industry consolidation, and the elimination of fixed fees charged for contributions.
- When properly measured, the fees and costs of funds in Chile, including default funds, are not particularly low by international standards for the investment allocations that those funds typically have.
- The Chile tender system unfairly favours new entrants as the only allowable fees that can be charged are related to the amount of contributions that are made. A fund will current low funds under management has lower investment costs and can profit from the fees that are set as a proportion of contributions.
- The frequency of the tender review is important. A review every two years, as is the case in Chile, would create greater uncertainty and compound the risks of negative outcomes for members.

The New Zealand Model in the Australian Context

- Nine institutions were selected in 2014 as "default providers" for new KiwiSaver members who do not nominate a place for their savings. The providers selected made up most of the then existing KiwiSaver market and will remain as default providers for a period of seven years, reinforcing their market shares.

[5] Productivity Commission 2012, p. 261

- Unless savers nominate a fund, the New Zealand Inland Revenue department allocates new KiwiSaver members a default provider or puts them with their employer's scheme if the employer has chosen one. About 22 per cent of the 2.2 million KiwiSaver accounts are in default funds.
- The fee savings for fund members have not been large and have been at the expense of higher investment returns over the longer term from other Kiwisaver products. For a typical $7,000 balance in the new default funds, the total fee on average has been estimated at approximately $56 a year compared to the average fee of around $69 for other KiwiSaver funds.

Arguably, neither the Chile or New Zealand tender systems deliver significant benefits in their respective countries and the case for their export to Australia is very weak.

Designing the Models - Insurance

The issues paper notes that:

> "*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.*"

We are concerned that the Productivity Commission is considering allocating default insurance arrangements in superannuation through a separate competitive process. This seemingly goes beyond the terms of reference of the inquiry. As noted in the issues paper "these Terms of Reference follow from the Government's response to Financial System Inquiry Recommendation 10 on efficiency in superannuation."[6] Recommendation 10 of the FSI was to:

> "*Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.*"[7]

In neither the headline FSI recommendation or the detailed commentary that precedes it is there any consideration of a separate allocation process in relation to insurance. We are not surprised by the FSI's lack of consideration in this respect, as the group insurance market has approximately 12 providers and it is not on the face of it apparent that a separate selection is warranted in such a limited market.

Unfortunately the issues paper does not elaborate on its inclusion of this matter and it is therefore unclear what is envisaged. This leaves a number of questions unanswered.

- On what basis is the Commission proposing a separate process for allocating default insurance products given that it is a very different market to default superannuation, which is the focus of the FSI's recommendation?
- What framework does the Commission propose is established to make determinations in relation to default insurance? Will there be prudential oversight from APRA?
- Is the Commission of the view that the process that is determined for the selection of default funds would be replicated for insurance, or will there be a separate, differentiated process in relation to insurance?
- Would the decision in relation to superannuation fund allocation omit to consider the insurance offering to members?
- Would the entity responsible for the selection of default funds be the same or would a separate decision maker with differing expertise be required?
- On what basis would the decision maker determine that particular insurance products were suitable/unsuitable to operate as default insurance offerings?
- Removal of group insurance from superannuation would mean that hard to insure groups such as miners, construction workers, emergency service workers, and some health workers would have great difficulty in obtaining insurance. For this reason alone, segmentation by occupation is an essential part of default super?

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[6] PC issues paper p.iii
[7] FSI Final Report p101

- How would the Commission's proposed process interact with trustees responsibilities in relation to establishing default insurance arrangements that are in member's best interests?
- Is the Commission proposing that an entity other than the trustee would decide what default insurance arrangements are in member's best interests? If so, would this decision maker be subject to prudential regulation in the same manner as trustees.
- How would Superannuation Guarantee and salary sacrifice contributions be split between the accumulation account and the insurance provider?
- How would the system cope with individuals with more than one job?

No group insurance is currently 'bundled' with default superannuation products. All insurers are a discrete provider to the super fund. The administrative processes behind the scenes, either in-house or via third party administrators, direct premium payments from member accumulation (investment) account balances, to the insurer who is providing the group policy. From time to time the insurer may change as the trustee reviews the suitability and pricing of a current provider and contracts to a new provider, usually via a competitive tender process. The construction of current default insurance arrangements occurs on an arms-length basis.

An additional selection process introduced in relation to insurance would add a significant layer of complexity into the system for no tangible benefit. It would be likely to lead to additional complexity and administration costs. Insurance is a component of the superannuation product selected and designed by the trustee, utilising the services of an appropriate group insurer, with member's best interests in mind. Insurance should be considered in the overall assessment of the superannuation product, just like all other components that make up the member offering, including for example investment arrangements.

We do not believe that a separate competitive process for determining insurance arrangements, or any other discrete components of the superannuation product for that matter, would lead to a more efficient system or improve member outcomes. Designing the overall product offering is a fundamental role for the trustee, underpinned by trust law and a strong prudential framework that protects members' interests.

As stated in our recent submission to the Commission on efficiency, we believe the objective of insurance in superannuation is as follows:

The superannuation system provides insurance that delivers valuable protection to the community and meets members' needs at reasonable cost.

We acknowledge that improvements to the system should be made in order to support this objective and ASFA is currently involved in collaborative efforts across both the superannuation and insurance industries to lift standards and improve outcomes for members. The matters that are subject to consideration include benefit design, insurance definitions, and claims processing.

Selection of insurers has not been identified as a problem area and in fact the current system works well in this regard. Trustees review their arrangements regularly and members benefit from a competitive group insurance market that facilitates the selection of insurers who meet members' needs at reasonable cost.

Below we outline the detrimental impacts associated with application of implementing a separate process for default superannuation fund allocation to insurance.

Usurping the role of the Trustee

Implementing a separate allocation process for insurance within superannuation *before* the trustee has determined its arrangements will usurp the role of trustees, who are under trust duties to provide insurance that is meeting members' needs.

Importantly, the proposed allocation of default funds (in any of the proposed models) occurs *after* the trustee has determined the settings for its default superannuation product, including in relation to insurance. It does not interfere with the trustee's role in determining appropriate product design settings but instead makes an assessment in relation to whether these are appropriate for default members.

Trustees' duties are reinforced through a governance framework that includes the funds' Insurance Management Framework and Insurance Strategy, developed in accordance with Superannuation Prudential Standards (SPS) which were issued as part of the rollout of the Stronger Super reforms, particularly SPS 250.

Trustees have made significant investments to meet the terms of these recently introduced prudential standards. We do not believe that effectively outsourcing the insurance selection process to a party who is not governed by the same high standard as trustees would result in better member outcomes. There is significant risk that the prudential framework would be undermined to the detriment of members.

A model where the trustee is no longer responsible for the selection of the insurer is highly problematic. A trustee is currently the owner of the insurance policy and has strict obligations to members in respect of operating the policy on their behalf. It is unclear who would bear the ultimate accountability for the insurance offered if insurance were designed and selected by a party other than the trustee and such a model would weaken the system immeasurably.

Reduced Competition in the Insurance Market

Group insurance is already a very competitive market in Australia. Insurance companies compete heavily through an effective Request for Proposal (RFP) process to win the insurance of a specific fund.

There is potential for the currently competitive group insurance market to be eroded through a separate "competitive" process (i.e. a process run by the government), if it supplants the existing competitive market process. Competition inherent in the group insurance market enables arrangements to meet the differential needs of default members on an ongoing basis.

A competitive group insurance market is a key reason that insurance premiums for group insurance in superannuation are much lower than those paid for individually underwritten retail insurance policies. When negotiating fund level group insurance contracts trustees can leverage wholesale bargaining power that arises when striking an arrangement for many members, rather than for an individual member. This, however, can only occur in the context of a competitive group insurance market with multiple participants.

A separate process would lead to fewer group insurance providers by promoting the selection of ultimate "winners" and "losers". This would lead to pricing power reverting to the hands of fewer insurers, eroding or eliminating the wholesale bargaining power trustees possess under the current model. This would ultimately be to the detriment of fund members.

Reduced Member Benefits

The market has continued to evolve as funds seek to better target their benefit design to their members needs and preferences. In recent years, more funds have undertaken consumer testing and research to inform benefit design. The benefits of this progress would be diminished if members effectively have their insurance arrangements pre-selected for them based on criteria that may not reflect their needs.

A number of superannuation funds have members who are predominantly from a particular industry with similar demographic characteristics across the membership base. These demographics are increasingly being taken into consideration when developing benefit designs and ensuring the right levels of default cover are in place to meet the needs of a fund's membership, together with flexibility to increase or decrease cover as suits their needs.

Some examples of benefits to members that can flow from these increasingly rigorous design processes include early intervention pre-claim, rehabilitation post-claim, and the removal of waiting periods. There is demonstrable evidence in the market of trustees designing appropriate default insurance offerings based on an ever deepening understanding of their member's needs.

Factors that may meet the needs of one cohort of default members may not be appropriate for another. The idea of a sound default offering should not be conflated with a one size fits all approach to product design. An additional selection process runs the risk of diminishing the significant member benefits associated with the trustee's determination and insurance selection process.

Pricing

Group insurance is based on a pooling of lives that, in the absence of individual medical underwriting, includes a selection of both good and bad risks. This means that members who may have pre-existing medical conditions, work casually or part-time or work in high risk occupations are generally able to access insurance cover through group arrangements at an affordable price – without the imposition of restrictions and exclusions or premium loadings, or even denial of cover, if they were to be underwritten for individual cover.

It is unclear what alternative model the PC has in mind, however we make the following observations with respect to potential pricing issues that may arise.

Accurate pricing is likely to be more difficult as an outcome of a separate selection process in circumstances where the pool of risks of less well understood. For example if there were only one default insurance provider across the entire market with different employment types and the member demographic is less homogenous pricing risk is more difficult and likely to be priced at the highest risk rating

Additionally, any form of imposed allocation that reduces the numbers of employees covered by any one insurance policy 'pool' would immediately compromise the price competitiveness of the insurance premiums for each member to bear. The two main strengths of having one insurance policy are the guarantee of (i) member numbers (insured lives in the pool) due to considered assumptions of opt-out percentage from the current and projected member numbers – this gives the benefit of volume to the pricing assumptions; and (ii) the minimum length of time during which the premiums versus claims ratio can evolve (generally 3 years) such that the members are paid claims and the insurer remains profitable and the policy remains sustainable for that pool of business, thus fulfilling the imperatives set down by SPF 250.

Simply put: why consider dictating a regime of a ‘panel’ of insurers that results in reducing the size of the pool (by forcing several smaller pools), forcing a potential insurer to cost for lower (and possibly inestimable) numbers than actually exist in the fund? This would either make tendering infeasible or at best reduce volume efficiencies and increase costs for any ‘approved’ insurer of the fund and this would be passed on in the premiums.

Active choice of fund by employee, like choosing bank account to receive wage

It has been argued by some that given that employees generally have to provide their tax file number and nominate a bank account to receive wages, then they should be able to nominate a superannuation fund to receive their employer contributions as well. However, as shown by the discussion below, there are additional factors to take into account in regard to selection of a superannuation fund by an employee.

Pros

Requiring a fund member to choose the fund to which contributions are made may in certain circumstances support greater competition with fund members responsible for deciding which fund was best for them.

It could also lead to relatively stable outcomes as individual decisions would be unlikely to lead to large shifts in market shares in the short term, with funds both gaining and losing members over time.

It could also be a relatively low cost arrangement in the sense that there would be no need for new administrative or institutional arrangements to be put in place. Some existing mechanisms could be dismantled. It would involve little or no cost for the Government in terms of ongoing administration, provided there were no significant irregularities in the providers’ conduct.

It may also make it easier for new entrants to gain market share, but there would be likely to be overall stability in the system without large movements over the short term with employees being assigned in bulk to a new default fund.

Such an approach could potentially drive greater member engagement given that employees would be expected to choose. Some might be engaged enough to undertake research and compare funds if they are forced to make a choice.

Placing the responsibility on the employee would reduce the burden on employers in terms of employers no longer having to select a default fund.

Cons

There is no real case anywhere in the world where all employees are required to nominate a superannuation or private pension fund before contributions are made, suggesting that this model may have limitations in practice.

Purchasing at an individual level often can involve greater costs than group arrangements selected on a group or wholesale basis given that an individual will not have much bargaining power.

An individual purchaser is likely to have much less information about funds on offer than providers. Information asymmetry generally is not supportive of strong price competition.

For an employer, there is likely to be an administration burden to follow up employees who have not nominated a superannuation fund. This may increase the risk that the employer does not comply with SG obligations.

It is possible that some employees, potentially a significant number, may not choose a superannuation fund despite repeated prompting. Given that superannuation benefits are generally not available until preservation age, which will be at least 60 for almost all new entrants to the labour force, there are no immediate consequences for the employee from failing to choose a fund. Employers would still need a default mechanism for cases where an employee has not exercised choice for the employer to be able to comply with Superannuation Guarantee requirements. In some cases an employee may have ceased employment with the relevant employer before a Superannuation Guarantee payment is required to be made.

The Australian Taxation Office might need to operate a facility of last resort for employers where an employee fails to nominate a superannuation fund. This would involve additional system costs and could lead to employees not being well connected to their superannuation account or accounts.

Most entrants to labour force will already have a bank account, but very few will have a superannuation account. A bank account is a relatively simple financial product, but a superannuation account, even a MySuper product, is much more complex and a new entrant to the labour force may not necessarily be well equipped to choose between funds. A bad decision made early in a working career through its impact on compound investment returns have a substantial impact on final retirement income.

There also would be additional costs in terms increased advertising and member communication to attract and retain members.

It is likely that expenditure by funds on advertising and sponsorship would increase substantially. New entrants to the market might struggle to gain market share as incumbency would give current large funds brand recognition amongst entrants to the labour force.

Default insurance arrangements may not be viable where new employees are exercising choice of fund.

Employers would be likely to have to contribute to more funds than is currently the case, although theoretically the costs of this should be kept low through the use of SuperStream and Single Touch Payroll contribution mechanisms.

Competition might focus more on both perceived and actual product characteristics rather than on administration costs and net return to the fund member.

Nudge members to high performing funds

Around the world there is increasing interest in the use of “nudges” to encourage desired outcomes rather than regulatory or administrative arrangements requiring certain behaviours. Current default arrangements (both in awards and more generally in terms of employers choosing a default fund) are an example of “nudge” arrangements, particularly where employees have a right to choose the fund to which their contributions and/or accrued balance should be directed. Nudges can work as an efficient alternative to compulsion on the one hand and open choice on the other. However, nudges generally are about doing an action or not doing an action (such as making more contributions) not the choice of a specific product or service once the action is decided upon.

The issues paper is not very specific in regard to the nudge mechanisms that might possibly be used. Reference is made to the need to undertake experiments to develop appropriate nudges. We note that "framing" of information to members, such as long term savings and return propositions, risk information, fees and statements is also very influential in helping members understand their super. However, it is fair to say that it is still early days in terms of understanding how members respond to framing and nudging.

Going forward, the enrolment process for new employees making use of ATO Single Touch Payroll processes could be considered a nudge for individuals with an existing superannuation account. Individuals are likely to be prompted to agree that future contributions should be directed to their existing fund if they have one. If most people are happy with their fund and do not want to have more than one fund, then making the default 'my existing fund' will be effective in reducing the number of multiple accounts. However, retaining the existing fund may not necessarily be a nudge to a "high performing fund".

Pros

Moving to a greater use of "nudges" (depending on their being appropriate) could support better outcomes for fund members to the extent that a number of funds were identified as being high performing and as a result gain market share through "nudging".

Such an approach is relatively simple and would not necessarily involve the creation of any new administrative or institutional arrangements other than the creation of arrangements to determine which funds should benefit from the "nudge".

Arguably, such an approach would build on market mechanisms and would strike a balance between individual responsibility and official guidance. It also would be consistent with relatively stable allocation of new employees to funds, depending on how frequently funds favoured by the nudge are selected or changed.

It would be likely to involve modest ongoing costs to the extent that it is built on existing mechanisms for evaluating funds.

Cons

The assumption that it would be easy to select preferred funds is questionable. It is unclear what mechanism would be available to identify "high performing funds" on a prospective basis and what the criteria for selection would be.

There would be legal issues relating to the provision of personal financial advice in terms of a nudge favouring a fund or funds over other funds. Apart from the legal issues, there could be a moral obligation on a government to pay compensation to fund members in the case of a recommended fund underperforming or sustaining losses on investments.

Adoption of a "nudge" approach also could restrict competition, depending on the number of funds to which employees are nudged and the frequency with which that list is changed to include new entrants or existing funds which are judged to have become high performing.

This approach also could provide scope for the selection of preferred funds to be manipulated as it is not clear what metrics would be used to select the preferred funds and whether those metrics could be gamed.

There also would the challenge of putting in place nudge arrangements when more than one fund is regarded by the relevant assessor (whoever they might be) to be high performing.

It also unclear what would be the nature of the “nudge”. The necessary experiments required for designing such a nudge are likely to be difficult to formulate and conduct. There also would be issues in regard to how the nudges could be delivered to new employees.

Existing nudges in the form of rankings and evaluations provided by rating agencies appear to have had limited impact on the funds that are chosen. The “official” nudges would have to compete with both existing ratings and any advertising by funds that may use similar communication techniques.

Such an approach would involve initial costs for the authority that evaluates funds and also for developing and testing nudge techniques. Ongoing costs would be involved for monitoring performance of selected funds and of possible replacement funds for those nudged. There also would be costs involved in terms of delivering the nudge to new employees.