October 2016

Superannuation: Alternative Default Models

Submission to the Productivity Commission

ABOUT US

Set up by consumers for consumers, CHOICE is the consumer advocate that provides Australians with information and advice, free from commercial bias. By mobilising Australia's largest and loudest consumer movement, CHOICE fights to hold industry and government accountable and achieve real change on the issues that matter most.

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CONTENTS

INTRODUCTION

CHOICE research shows that consumers find superannuation products to be some of the most difficult to choose.[1] Inherent biases in consumer decision making lead to a focus on the present rather than the future. This is particularly problematic in the superannuation market, as it is a product that will only be relied upon in the future.

Given the amount of consumer money invested in superannuation and the importance of the system to helping Australians in retirement, it is vital that a default model delivers the best outcomes in the long-term interests of consumers. Any model needs to balance the best outcomes for consumers less likely to engage with the need to drive member engagement. While employers arguably have more interactions with default funds than members, any model that gives employers a role in selecting default funds has a strong potential to distort the market away from member interests. Under these conditions, finding a way to deliver demand driven competition is highly complex.

The primary focus of the Productivity Commission should be on ensuring there are robust default products and an allocation model that most closely aligns with member needs. We recommend that, as a starting point, the MySuper default form the building block for appropriate metrics in fund selection, although we acknowledge the PC's competition and efficiency review of the superannuation system may recommend further refinements to these defaults.

We recommend the system be open to opportunities to insert consumer choice for existing members (those who are in funds established prior to the introduction of the allocation scheme). Any consumer choice needs to occur with an appropriate safety-net in place. Where consumer choice is encouraged consumers should only be directed to 'filtered' default funds via the allocation model.

CHOICE has no strong preference about the specific form of a default allocation process. Instead, we have articulated principles that any system should be built around. These principles are that:

- any allocation process be run by and in the long-term interests of members with independent oversight.

[1] CHOICE, 2016, 'Consumer Pulse: Australians' attitudes to cost of living 2015-2016', July 2016

- the system should ensure all employees can access competitive defaults.
- life insurance defaults are closely aligned with members needs at competitive prices.
- employee segmentation should be pursued where the benefits outweigh the costs.

In addition, we have called for greater thought on how to prompt consumer engagement with superannuation. Using the insights from CHOICE research into member engagement, we recommend that a centralised ‘one-stop-shop’ for superannuation fund selection and consolidation be created via the myGov website to help all consumers assess and more regularly switch to better products

1. Corporate fund comparisons

There are a number of unanswered questions over the benefits of a model based on the corporate tender process model. Caution should be exercised in extrapolating benefits seen under this model to the broader market.

The Financial System Inquiry (FSI) acknowledged the need for the current Productivity Commission review into competition and efficiency in the superannuation market as a necessary precursor to further reform.[2] The FSI also noted it had reservations about whether the Stronger Super reforms alone would significantly improve system efficiency and member outcomes.

The FSI, on which the terms of reference for this inquiry are broadly based, recommended a formal competitive process for fund allocation unless it was found that the Stronger Super reforms had significantly improved competition and efficiency. This was influenced by evidence of large corporations being able to gain comparatively lower fees for employees by tendering for a default superannuation fund.[3] Given this is the foundation on which the current inquiry is at least in part built it is important to analyse the strengths and weaknesses of the corporate tender process.

Possible benefits of corporate tenders

At the macro level, there is some evidence that corporate funds have been effective in driving down fees. The FSI cites lower acquisition costs as the primary benefit of corporate fund

[2] Financial System Inquiry, 2014, ‘Financial System Inquiry – Final Report’, p.91
[3] Financial System Inquiry, 2014, ‘Financial System Inquiry – Final Report’, p.91

tenders. Unpacking this further, there are other factors at play in the corporate fund market. It is unclear if these benefits can be transferred beyond the particular circumstances of the corporate fund environment to a market-wide effect.

Insurance premium levels are one area where corporate funds appear to have an advantage over other fund types. From 2011 to 2015 corporate funds were able to reduce average death and temporary and permanent disability (TPD) premiums by 4.0-6.2%.[4] Over the same time period average premiums have increased by up to 45.1% for industry funds and 4.1% for retail funds.

Despite the smaller increases Chant West data indicates that death and TPD group retail insurance had the highest premiums.[5] Public sector funds are among the cheapest and industry and corporate funds are in between the two.

Corporate tenders are run for a very particular group of employees. There are a number of efficiencies funds can pass on to members where they have a better understanding of the membership base. Particularly among well-established non-public offer corporate funds (e.g. Telstra, QANTAS and Commonwealth Bank) there is likely to be well developed expertise in risk faced by employees through workplace health and safety obligations. This can help insurers quantify risk and offer more competitive premiums.

Another factor behind lower fees may be that large corporations tend to have more sophisticated payroll systems, and may only deal with one employer.[6] This can mean they have cleaner and cheaper contribution collection systems, making them relatively more efficient than other fund types.[7] As the Productivity Commission has noted, there is insufficient data to make conclusions on these observations and more detailed analysis is required on costs and fees to determine where savings are coming from.[8]

Possible costs of corporate tenders

Superannuation is for members, not employers. Any tender process led by or involving employers risks creating a system built on conflicting interests. CHOICE is concerned that a corporate tender process will lead to poor outcomes for consumers and risks placing business

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[4] SuperRatings, 2016, 'Insurance – When is enough, enough?', available at: http://www.superratings.com.au/media/mediarelease/020516
[5] Chant West, 2014, 'At Last… a Simple Way to Assess the Competitiveness of Super Fund Insurance', available at: https://www.chantwest.com.au/resources/simple-way-to-assess-super-fund-insurance
[6] Productivity Commission, 2016, 'How to assess the competitiveness and efficiency of the superannuation system – Draft Report', p.207
[7] Productivity Commission, 2016, 'How to assess the competitiveness and efficiency of the superannuation system – Draft Report', p.207
[8] Productivity Commission, 2016, 'How to assess the competitiveness and efficiency of the superannuation system – Draft Report', p.207

needs ahead of member outcomes. The evidence from Industry Super Australia (ISA) shows a lack of oversight and probity in corporate tender processes, which in some cases has led to employer interests being put ahead of members.

CHOICE shares the concerns of ISA around evidence of:[9]

- employers selecting funds based on maintaining relationships with key financial clients,
- banks offering incentives to employers to sign up employees to retail funds owned by the bank,
- tender consultants receiving a fee per member signed up from the winning fund,
- fee discounts that cease if an employee leaves their current employer.

Cases where corporate tenders have seen employer interests put ahead of the long-term interests of fund members is extremely concerning. It points to the risks of any system where decision makers have interests that do not align with those of members. It also demonstrates the need for an independent party to at minimum oversee the allocation process or preferably, be responsible for the allocation process.

Recommendation

That any allocation process be run by and in the long-term interests of members with independent oversight.

2. Identifying employees

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

The PC has taken the view that a new default allocation model should cover employees starting a new job who do not make an active choice about their superannuation fund. CHOICE agrees this is the best way to drive competitive outcomes for new employees who are not making active decisions. However, we also see scope to use the model developed to assist decision making for existing members (e.g. nudges to review better offers) and those exercising active choice (e.g. through access to product comparison information developed through the process).

[9] ISA, 2016, 'Submission to the Productivity Commission's superannuation competitiveness and efficiency inquiry', p.54

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

Yes, the system should ensure all employees can access competitive defaults. Any possibility for flow on benefits to existing members should be incorporated into the model.

Placing too much emphasis on creating competition for new rather than existing members may see legacy members left on uncompetitive products. Research conducted by QUT found that Australians' could save more than $11.6 billion a year if they were willing to switch a range of financial and utility products.[10] More than 50% of Australians have seriously considered switching their home loan, credit card, home insurance, energy supplier, groceries main supplier, mobile phone and internet providers, but less than 25% acted on those intentions.

Actual switching rates for superannuation are much lower when compared to the financial and utility products mentioned above. Roy Morgan research puts the rate at only 3.2% a year, while the ATO points to a rate of 9% annually.[11] 50-80% of switching has been simply due to a change of jobs or an employer changing default funds, both of which would be counted as new default members under the proposed model.[12] This means that at best annual switching rates for existing members is less than 5% (at worst it is less than 1%), which is unlikely to be enough to drive competitive tension for this large portion of the market.

Rice Warner research found that the fees charged for legacy retail products were 29% higher than those charged for current superannuation products. [13] It also estimated that in 2014 around 30% of retail personal superannuation assets were held in these higher fee legacy products.[14] This is a clear indication that if efficiencies are to be gained, thought needs to be given to how existing members can benefit from a new default allocation model.

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[10] QUT, 2015, 'Australians' switching behaviour in banking, insurance services and main utilities', prepared by Dr Juliana Silva-Goncalves on behalf of Heritage Bank.

[11] Roy Morgan Research, 2016, 'Over $35 Billion in Superannuation Switched but Nearly One Third of Switchers Didn't Get Any Advice' available at: http://www.roymorgan.com/findings/6617-over-35-billion-in-super-switched-but-nearly-one-third-didnt-get-advice-201601052255 ; Colmar Brunton 2010, 'Investigating Superannuation: Quantitative Investigation with Superannuation Consumers', Final Quantitative Report, prepared for the Australian Taxation Office, Canberra.

[12] Fear, J. and Pace, G. 2008, 'Choosing Not to Choose: Making Superannuation Work by Default', The Australia Institute and Industry Super Network, Sydney ; Cooper, J., Casey, K., Evans, G., Grant, S., Gruen, D., Heffron, M., Martin, I. and Wilson, B., 2010,' Super System Review Final Report - Part One: Overview and Recommendations, Final Report', Canberra.

[13] Rice Warner, 2014, 'Superannuation Fees Report 2014', Financial Services Council, available at: http://www.fsc.org.au/downloads/file/ResearchReportsFile/FSCSuperannuationFeesReport2014FINAL.PDF, p.26

[14] Rice Warner, 2014, 'Superannuation Fees Report 2014', Financial Services Council, available at: http://www.fsc.org.au/downloads/file/ResearchReportsFile/FSCSuperannuationFeesReport2014FINAL.PDF, p.26

The Chilean scheme involves a public tender system. [15] The tender process takes place every two years with funds bidding to be the default fund for new members. New members are obliged to join the default fund until the end of the fund's 24 month default term. The Chilean system attempts to address the issue of low switching by ensuring offers available to new members are also open to existing members. The FSI also made this recommendation.[16]

Given the low rates of organic switching in superannuation, this alone may not drive competition for existing members. Drawing on behavioural research there may be opportunities to improve levels of switching to more competitive products, but ultimately any allocation system needs to also meet the needs of consumers who are already part of the superannuation system and who are most likely paying higher fees for poorer outcomes.

3. Complementing an allocation model with consumer choice

According to the FSI and noted in the terms of reference, the absence of consumer-driven competition is a major reason for fees not falling as much as expected despite the massive increase in scale of the industry.[17] Designing a model which doesn't require consumer engagement will not reverse this situation.

Under the right conditions consumer choice could be safely exercised and encouraged in order to boost the competition outcomes of an allocation model.

CHOICE research into consumer engagement with superannuation

CHOICE has conducted research which explores how fund members currently think and feel about superannuation, how they currently engage, and what would prompt them to become further engaged. The research focuses on how to assist consumers to take steps that would improve their balance over time and ultimately their retirement income.

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[15] Chilean model as discussed in the issues paper.
[16] Financial System Inquiry, 2014, 'Financial System Inquiry – Final Report',
[17] Morrison, S., 2016, 'Terms of reference – efficiency and competitiveness of the superannuation system', available at: http://www.pc.gov.au/inquiries/current/superannuation/terms-of-reference

To understand how the barriers and triggers to engagement differ across different groups, the research focussed on young adults, new mothers and pre-retirees—three groups at important life stage points for superannuation engagement.

The research found that consumers are more likely to exercise choice if a series of preconditions are met.[18]

Whichever allocation model is developed, one of its outputs is likely to be a list of competitive funds with favourable terms for consumers. This list could have valuable flow on benefits to existing members if it is translated into a form that is meaningful for consumers and takes on board the findings below.

Central place and time

The idea of myGov housing a centralised 'one-stop-shop' for superannuation management was extremely appealing to research participants. The current ability to consolidate funds through myGov could be extended to allow funds 'filtered' through the allocation process to be compared to an existing fund. Encouraging a superannuation fund 'check-up' around tax time through myGov could create a healthy focus on superannuation and remove the 'chafe' from current efforts to compare and consolidate funds.

Digital decision-making tools

Participants did not want more information – they wanted help to make decisions. There is an opportunity to develop digital tools that streamline decision making, simplify the options for consumers and recommend the best options. The ability to personalise tips and advice to the individual was identified as critical in the success of these types of tools.

Opt-in reminders for monitoring

People need reminders or a 'nudge', especially when they are avoiding something (e.g. the dentist or their taxes). Superannuation is no different. People welcomed the idea of opting-in for regular reminders/alerts for superannuation 'check-ups' annually (or every two years). This would ensure that superannuation stays on the radar, and prompt more regular consideration and behaviour around superannuation – e.g. reviewing finances more regularly, tracking progress. Like savings, consumers are likely to feel empowered as they see their superannuation grow in small steps, and may feel more inclined to accelerate its growth when they can through voluntary contributions.

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[18] Pollinate, 2016, 'Project Superpower – informing a strategy to engage people with their superannuation', Research commissioned by CHOICE, p.32, available at: https://www.choice.com.au/money/financial-planning-and-investing/superannuation/articles/why-consumers-avoid-thinking-about-super-20161024

Independent and trustworthy information
The research showed many consumers had lost faith in the super funds or financial advisors to help them with decisions around superannuation. What they were after was independent, unbiased advice in their best interest.

The biggest concern with private sector provision of information is how the business model impacts on the quality of the information provided. Many comparison tools that operate on a for-profit basis are funded through a commission structure that is poorly disclosed and affects the quality and presentation of results.

Further layer of protection
CHOICE is also concerned that where consumers exercise choice beyond the safety net of the 'filtered' list they should be fully informed of the implications. One option is to require active informed consent where consumers elect to take products that do not meet default model protections. This is a model used in the telecommunications sector to ensure consumers are fully informed of the implications of moving away from products that have robust consumer protections.[19] The model is useful as consumers are given a clear prompt indicating that a service does not meet key standards and are given an opportunity to consider this impact on their personal situation.

Recommendation

That a centralised 'one-stop-shop' for superannuation fund selection and consolidation is created via the myGov website to help all consumers assess products and switch to more competitive offers.

4. Specifying a competitive process to determine default products

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

[19] ACMA, 2016, 'CSG standard: Your rights', available at: http://www.acma.gov.au/Citizen/Phones/Landlines/Phone-connection-and-repair/waiver-of-rights-under-the-csg-standard-fact-sheet

Until the PC has completed its analysis of how well MySuper products are performing it may be premature to suggest changes to the existing set of default features. CHOICE has raised a number of concerns around existing defaults through its Superannuation Competition and Efficiency submission.

While we do not believe the case has been made to end default opt-out insurance arrangements, we have questioned how closely aligned some of this insurance is to the needs of younger people and noted that many consumers may be paying for multiple insurance across duplicate accounts for little or no benefit. We look forward to further assessment from the PC about how these issues with opt-out insurance can be addressed to improve group insurance arrangements.

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?

The principle should be to closely align insurance defaults with members needs at competitive prices.

Unbundling insurance products and allocating them through a separate, competitive process should improve allocative efficiency and potentially deliver consumers insurance products which are more aligned with their needs. Quantification of the administrative costs involved in running two competitive processes needs to take place. Also data is required around any efficiency benefits that flow to members as a result of bundling these two products. However there are a number of known benefits to unbundling which have the potential to outweigh these costs.

It could potentially lead to the development of products that are a better match to the diversity of working arrangements and fund balances across the community. For this to be achieved, the allocation process, like with superannuation allocation, will need to be run by an independent party guided by the long-term interests of members.

The role of the allocation body could be greatly simplified if superannuation fund and insurance policy allocation were separate processes. The difficulties of comparing bundled superannuation and insurance products are not limited to individual consumers. As the PC notes, the difficulty in comparing insurance products often results in insurance being excluded from a corporate tender where members are being transferred between funds.[20]

Known quality and pricing issues with group insurance

Group insurance premiums have been steeply rising. Recent APRA data shows insurance premiums rose 7.5 per cent across the superannuation industry during the 2015/2016 financial year.[21] The average increase in premiums for death and TPD cover over the past 4 years has ranged from 29.0% - 45.1% for not for profit funds and increased by an average range of 2.0% - 4.1% for retail funds,[22] although it should be noted retail premiums are on average higher than industry funds.

Price rises appear to be a temporary phenomenon as industry better accounts for risk. In this environment it is difficult to draw firm conclusions about how competitively insurance premiums are priced.

The industry is dealing with the problem of pricing risk by not just raising premiums, but by altering terms of insurance policies to decrease benefits for members. There is a risk that these reductions mean some group insurance policies may no longer be relevant to large sections of a member base. For example, one policy does not pay out a claim where a superannuation balance has dropped below a certain amount.[23] For a product which was designed to be offered on a universal default basis, this type of limitation is particularly worrying. These clauses potentially make policies worthless for those with low balances.

Some of these issues may be best addressed through an allocation process focused on insurance quality.

Accounting for behavioural biases

Currently 4 of 5 consumers have never analysed the type or amount of life insurance that suits their own circumstances.[24] A competitive allocation process can help overcome this lack of consumer consideration on life insurance needs and offer products which better match needs based on demographic markers.

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[20] Productivity Commission, 2016, 'How to assess the competitiveness and efficiency of the superannuation system – Draft Report', p.205
[21] APRA, 2016, 'Statistics – Quarterly Superannuation Performance', issued 23 August 2016, available at: http://www.apra.gov.au/Super/Publications/Documents/2016QSP201606.pdf
[22] SuperRatings, 2016, 'Insurance – when is enough, enough?' available at: http://www.superratings.com.au/media/mediarelease/020516
[23] REST, 2016, 'REST Super Insurance Guide', available at: http://www.rest.com.au/getdoc/bda653b8-3f6f-4831-b573-f8f36f74916f/RE626_REST-Super-Insurance-Guide_LR_WEB.aspx , p.13
[24] Zurich Australia, 2014, 'Australians and Life Insurance: Misinformed, Misinsured?', Sydney.

From a behavioural perspective, bundling, which can result in complex pricing, may increase the costs of searching for the preferred choice, thereby reducing consumer welfare.[25] This is due to the need for consumers to obtain information and learn about the various quantities, quality and price combinations offered by a range of suppliers. Studies have shown that consumers make systematic errors when assessing the worth of bundled goods and/or services.[26] These errors may advantage producers at the expense of consumers.[27]
Given the behavioural complexities noted in the research around consumer decision making, there would also be a large benefit in making comparison analysis data publicly available to aid existing members find suitable insurance products.

Recommendation

Further explore the costs and benefits of allocating life insurance through a separate competitive allocation process that includes an independent party assessing options in the long-term interests of members.

5. Allocating employees to eligible default products

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?

At a principled level employee segmentation should be pursued where the benefits outweigh the costs.

Complexity is added to a model which requires segmentation, however there are some broad demographic levels of information which could be better harnessed to better align funds with member needs. There may be significant benefit in pursuing 'smart defaults' based around age and occupation, for example:

- Tailored insurance for high risk occupations,

[25] Papandrea, F., Stoeckl, N., Daly, A., 2003, 'Bundling in the Australian telecommunications industry', *Australian Economic Review* 36 (1), 41-54.
[26] Heeler, R.M., Nguyen, A., Buff, C., 2007, 'Bundles = discount? Revisiting complex theories of bundle effects', *Journal of Product and Brand Management* 16 (7), 492-500.
[27] Estelami, H., 1999, 'Consumer savings in complementary product bundles', *Journal of Marketing Theory and Practice*, 7(3), pp. 107-114.

- Age based investment strategies (e.g. higher risk for younger people who have time to ride out the fluctuations in the market and lower risk for those who will be soon relying on a stable retirement income)

Industry-based needs have been traditionally accounted for through allocating appropriate funds through awards. There is a risk that moving away from this model without factoring in this level of tailoring will see consumers' allocated to less appropriate funds or insurance.

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

Where multiple default products are chosen by an allocation model there is an opportunity to give consumers choice over their product allocation. Effort would need to be made to ensure information about these choices was provided in an easily digestible format, for example a product comparison tool. Consumers who do not make a decision could be randomly allocated amongst the approved funds however it would be preferable if consumers were allocated based on a model which accounted for specific needs (e.g. demographic data as outlined above).

6. Model selection

The issues paper notes that market based models are generally more efficient than administrative models, even in the presence of market imperfections.[28] On the available evidence CHOICE does not express a strong preference for a particular model. However, we maintain that a key objective of any model should be ensuring the long-term interests of consumers are met.

The concept of the long-term interest of consumers or 'end users' is a commonly used objective in highly regulated markets.[29] The objective helps to clarify competition and efficiency based regulatory objectives in situations where ideal market conditions are not present. Therefore it can provide useful guidance to the development of a model design for default fund allocation.

Both the administrative and market models described have a similar element at their core. They require a set of metrics against which to judge the suitability of funds. These metrics will necessarily influence the development of the market and how product offers evolve. Funds are

[28] Productivity Commission, 2016, 'Superannuation: alternative default models', p.15
[29] *Competition and Consumer Act 2010* s152AB

likely to compete strongly on these metrics in order to compare favourably through either an auction/tender on administrative process. There is always a risk that top down metrics acting as a proxy for consumer demand will not necessarily match demand under ideal market conditions. To counter this risk, elements of consumer choice should be built in to the model.

What metrics should be used and how prescriptively should they be specified?

The MySuper requirements should be the starting point for a set of metrics, the PC's findings on the competition and efficiency outcomes in the system will provide an opportunity to refine and add new metrics as required.

Should the metrics be quantitative, qualitative or a mixture?

A mixture of metrics should be used. Quantitative measures tend to dominate in the financial services market. This often ignores extremely important consumer measures of value such as customer service.

Should there be a cap and/or floor on the number of qualifying products?

Whichever model is adopted its core principle should be to ensure it acts in the long-term interests of consumers. There is a risk that a model may lead to short-termism if the pool of successful tenders is small. A small pool is likely to encourage heavy discounting in order to maximise market share through the chosen allocation model. This may be done in a hope of harnessing economies of scale, which may fail to materialise. While consumers may benefit in the short-term this approach may lead to system instability in the long-term.

Like market share caps, a cap on the number of qualifying products which is too low may unnecessarily limit competition. It would be better to base the system on a standard which products must meet, then progressively lift this standard in an attempt to drive competition.

How frequently should the process be run?

The process should be run as often as is reasonably necessary to match major product changes, account for market consolidation and be sufficient enough to provide opportunities for new market entrants.

Who should administer the selection and subsequent monitoring of products?

A body tasked to act in the long-term best interests of consumers should be responsible for selecting and monitoring products. CHOICE does not express a preference for which body performs this function.

Any administrative model should be informed by groups representing superannuation member needs. CHOICE would be extremely concerned if employer representatives had a role in deciding the default products.

What might be the role of MySuper in the long term under this approach?

Pending further assessment of the impact of the policy, MySuper is a useful starting point for developing a filter against which products could be measured.

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

An intervention here would be one way to ensure existing members have access to the right ‘nudge’ to ensure they are engaging with their superannuation at the right times. Consumers could be informed that their existing fund no longer meets approval under the filter. This would also drive competition among funds for existing members, as the threat of falling off the list would likely lead to a loss of members.