

Submission re: the draft report in the inquiry Superannuation: Alternative Default Models

Jim Minifie
Productivity Growth Program Director
Grattan Institute
1 May 2017

I welcome the opportunity to make a submission in response to the Commission's draft report on Superannuation: Alternative Default Models.

Introduction

This submission proposes new analyses that may help the Commission as it creates a robust final report and so builds confidence that the next round of reforms to the Superannuation system will be strongly to the benefit of ordinary default members.

It is the superannuation system's members, not the funds, who are its *raison d'être*. The Commission should continue to bear in mind that the average default member is not as well-informed, not as financially expert, and not as well-funded as the superannuation funds that are making articulate, well-argued submissions to the Commission.

Default funds play an important role in the broader context of a superannuation system that should provide choice to all members. Even if fund members are not ‘engaged’, they must be able to rely on defaults to generate strong risk-adjusted returns (and an appropriate level of risk) on their mandated contributions over a working lifetime. As government seeks to improve the quality of default superannuation, for example by further restricting the list of eligible default funds, it inevitably risks being perceived as taking more responsibility for member outcomes. But this responsibility is already heavy, because government mandates that people must pay an amount equal to almost 10 per cent of pre-tax wages and salaries into superannuation.

The Commission’s draft report recognises the obligation of superannuation system designers to ensure defaults are delivering. It recognises that most members will not have the skills to weigh up a wide range of products. It sets out the strengths and weaknesses of alternative models, rather than closing early on a single option. It recognises the value of central clearinghouses and improved and comparable fund information. And it recognises the potential benefits of limiting account proliferation, though it arguably overplays them compared with the other main causes of excess cost: failures of funds to merge, high margins, and unwarranted investment expenses on fully active management of large-cap equities.

As the Commission continues to develop its analysis and recommendations, it should **round out the design and assessment of options, consider additional models, and deepen its analysis of the ‘root causes’ of system and fund performance.** Potential changes to the system must be designed and evaluated in detail in light of a wide range of high-quality evidence so that the the performance of the system can be improved.

1. Round out the design and assessment of options

First, the Commission should further develop the design and assessment of the four options it put forward in the draft.

i) Across all models: review the risks of upsell and gaming

It should **analyse all four models in more detail** to achieve much greater confidence about their likely performance:

- The Commission should **give close attention to the risk that funds that win default status will then seek to market other, less suitable products** to members. The draft discusses upsell in the context of the auction or tender models, but upsell could well be more

prevalent where individuals or firms are selecting default products. As one example of the type of analysis that could be done, the Commission could place a data request to APRA or to superannuation funds to establish how much of the \$70 billion or so in accrued default amounts remaining at the start of the extended Mysuper transition period were upsold into inferior products rather than transferred into MySuper products, and which funds or fund types were most responsible for upselling in this way. The Commission should examine the merits of options to limit upsell, such as restricting any marketing contacts for a fixed number of years after acquiring a new default member.

- The Commission should **test how robust each model is to competitive games**. For example, it should assess the risks that some funds may:
 - Hide fees by reporting gross returns that are net of broking costs, rather than reporting broking costs as part of the fee;
 - Report performance pre-tax or against inappropriate (eg non-risk-adjusted) benchmarks;
 - Use low-quality passive products that fail to track indices or fail to realise tax advantages (eg by using derivatives that do not attract franking credits, or turning over excessively, missing out on capital gains discounts);
 - Bid on a more expensive asset allocation (eg with a high proportion of unlisted assets), then migrating to lower-cost exposures (eg reducing the quality or quantity of unlisted exposures).
- The Commission should **evaluate what role might be permitted for performance fees** for asset managers, and what type of **entry and exit fees** are permissible both at the level of the member product and the wholesale asset.

ii) For the employee and employer choice options: evaluate the likely cost of marketing efforts

In addition to the above analyses, the Commission should **assess the risk that objective selection** by employees or employers **will be undermined by marketing efforts**. These two options rely quite heavily on the ability and interest of what are in many cases disengaged or inexperienced default members and employers. If the shortlist is merely an advisory one, superannuation defaults will be attractive targets for aggressive marketing from funds, including for suboptimal MySuper products (if the category still exists) or indeed for non-Mysuper plans. The Commission

should evaluate the likely costs of marketing efforts (including the selection of suboptimal products, not just excess marketing expenditures) and their impact on member returns:

- As an example of the type of analysis that could be done, related systems elsewhere in the world could be assessed quantitatively. Systems with full retail competition around the world tend to have quite highly dispersed fees. The US 401(k) system shares some features with the employer choice option. Average 401(k) fees have come down over time, and the fees attained by some plans are low, but there is a large tail of highly uncompetitive plans. The Commission should recognise that while a tough pre-screen may reduce marketing costs for the default products (because new default customers will be less attractive), it may increase marketing costs for non-default products and increase upsell efforts directed to default members or firms (for the same reason).

iii) On tenders and auctions: undertake the next level of design, including for asset allocation adjustments

The Commission should **design the tender and auction in more detail**, and **test in more detail the bidding tactics, risks and likely outcomes of each option**. It should:

- **Design and evaluate** in detail the option of **combining an initial selection** of a relatively large group of winners (perhaps 10-20) by a fee-based auction or a tender (or, which amounts to much the same thing, a ‘tougher’ MySuper qualification process), **with a subsequent continuous ‘tournament’** based on net performance (measured over a long enough period, and perhaps risk-adjusted, to ensure inappropriate risk-taking is not rewarded). Funds that ranked highly in the tournament over a given period could be allocated a larger share of incoming default accounts in subsequent years.
 - This hybrid model may have two significant advantages over a one-off tender or auction. It would permit a longer list of winners in the first stage, taking pressure off the ex-ante assessment (and mitigating concerns about politicisation or questions about the independence of the shortlisting process). It would subject all winners to continued competitive pressures ‘ex-post’, while providing them with leeway to adjust asset allocation or investment style.
 - Such a model was recommended in the Centre for Market Design draft report to the Financial System Inquiry (available from Treasury).
 - That report recommended significant additional design and assessment be undertaken: “an actuarial cost-benefit study to quantify the costs and benefits of the

proposal”; “a systematic study of the incentives embedded in the scheme, including if appropriate laboratory experiments, to evaluate the robustness of the scheme to gaming and collusion; “a systematic study, including if appropriate field experiments, of mechanisms to improve communication with and financial decision making by consumers, including shadow billing; and “If feasible, a pilot study and evaluation should be undertaken before implementation.” **The Commission should undertake this detailed design work. The appropriate time to do it is now -- in completing Phase 2. Phase 3 would be too late.**

- **Test options for specifying strategic asset allocation** or risk (‘factor’) exposures:
 - How should initial exposures be specified? How should the selector specify or manage exposures to international assets, unlisted assets, derivatives, etc?
 - Do the models differ their ability to tap into higher returns or greater diversification from illiquid assets? (This may become more important in the future if unlisted assets continue to grow in importance, as they already have in some markets).
 - What role will fund trustees retain? How would winning bidders be permitted or incented to rebalance their portfolios? What happens when a previously selected default provider underperforms?
 - Per the discussion of the ‘auction plus tournament’ model above, the Commission should evaluate whether it or other variants have the prospect of reducing how prescriptive the ‘selector’ would need to be over asset allocation.
- **Assess what would have to be true to select a multidimensional tender instead of a fee-based auction** and determine whether those things are true. (The tender could be a hybrid [as canvassed in the Grattan report *Super Savings*]: purely fee-based for the asset classes where there is strong evidence that passive exposures are adequate, but multidimensional, with a role for past performance, for other asset classes.)

2. Consider alternative models

In addition to the ‘auction plus tournament’ model set out above, the Commission should also **consider alternative models**. In particular it should consider:

- **Expanding the proposed coverage** of its default arrangements. The draft report proposes restricting the new defaults to the ‘first-timer pool’ of new labour-force entrants (and existing default members of winning funds). This looks like too slow a ramp-up. The inflows of new

workers are scarcely more than 1 per cent of inflows into MySuper products and of course their 'back book' is zero. Many more people switch jobs (the 'job turnover pool') than join the labour force each year, and most of them already have super balances. Including them in the plan would boost its coverage and make it more attractive for funds to compete. The default could be provided along with a clear choice to stay with current provider.

- It also should **compare the options directly and objectively against today's default arrangements** (including a version of today's arrangements where the link to awards is maintained but award lists are updated by the FWC, as envisaged but not yet undertaken). In principle this could be done in Stage 3, but at the very least preliminary work should be undertaken in the current phase. That would provide guidance for Stage 3 work, including how the assessment criteria for defaults relate to the broader assessment to be undertaken in Stage 3. But it would be wiser to set out now very clearly 'what would have to be true' for the alternative models to be preferable to today's default arrangements and design the analyses that will establish whether those things are true or not. The entire point of the 3-Stage exercise is to guide policy action by ensuring the assessment done in Stage 3 has clear policy implications.
- It should also flesh out the prospect of **using two or more options together**. A natural pair would be a tender model for workers that switch jobs, with MyGov or the ATO making it easy for others to switch to the tender winners by choice. That combination would help to maintain performance pressure across the system - not just on defaults.
- It should **review the case for a more full-featured default**. Arguably the draft has pared back the product specification too far (Figure 3.2), removing many product features that even default customers may well value, even if they do require some level of engagement. Default products should not be assumed to be products only for the utterly disengaged. Removing features from the default in this way will make upsell much easier and will reduce the number of members who stay on an otherwise attractive core default product.
- Finally it could also **consider the merits of a hybrid system** with two competitions (one at the admin layer and one at the investment layer). Selecting a single integrated retail offer may provide strong competitive advantage to large incumbent superannuation funds with existing strong bargaining power vis-a-vis asset managers. The draft report appears to assume that the only reason to implement wholesale competition would be to reduce average costs, and that this would have to be done with a government 'administration' layer. But in fact the main advantage of a two-level competition may come from the ability to combine entrants at one or both levels. Otherwise the winners of a tender are likely to be the largest incumbents, and over time that might result in further consolidation of the industry being dominated by those funds, which might not be optimal.

4. Deepen analysis of why costs and performance differ across models and jurisdictions

The final report should give more detailed and quantitative attention to **root factors behind the cost and performance of default systems** around the world and to the **root factors behind the cost and performance differences between funds of different types in the Australian system today**.

Such analyses can be informative for the Commission's current Inquiry, because they help to clarify what is important in the performance of alternative models that are operating in practice (whether as entire systems or as fund types within a single system). The analyses can also quantify the likely performance of today's default funds and alternatives to the current arrangements, including the likely range of winning bids in a major tender, given a range of characteristics.

In the Australian system, there are significant differences in cost and asset allocation across corporate tenders, retail, non-profit and public sector funds, and also across funds of different scales. Research houses and consultants already do some such comparisons today, and the Grattan reports *Super Savings* and *Super Sting* investigated what accounted for differences in performance between funds over time periods as long as the data permitted, including for-profit / not-for-profit status; asset allocation and investment returns. Those reports also separately analysed investment and administration costs, including the role in the Australian system of excess accounts, subscale funds (in excess numbers) and the role of margins (in the case of for-profit funds). *Super Sting* also provided some analysis of the drivers of costs across different systems around the world.

Important driving factors may be non-profit provision or the award qualification process (for all its imperfections). The 'competitive models' considered by the Commission's draft report are all neutral with respect to for-profit or not-for-profit status. Nevertheless, the not-for-profit funds, on average, have outperformed many others over the long run. The industry fund leaders strongly outperform leading retail products, though there is an underperforming tail of smaller industry funds.

The Commission should **work to understand the role played by the competitive environment and the not/for profit status in influencing the cost structure, asset allocation and performance of different fund types**. It is vital that the Commission understand to what extent the relatively strong performance and low fees of many corporate, industry, and public sector funds, and (in the case of industry funds) the relatively high allocation to unlisted assets is a function of nonprofit status, of the current default member allocation process, or some other factor.

For example, there is not much difference between the fees charged by for-profit funds for large corporate tenders and those charged by large lean not-for-profit funds. Overseas, fees are often low for not-for profit systems, but many of these are defined-benefit systems with lower administration fees (though investment fees also appear to be significantly lower). Similarly, industry funds have much higher asset allocation to unlisted products, which have outperformed at least on a non-risk-adjusted basis and probably on an adjusted basis.

5. Undertake further analysis on transition, insurance, and other implementation issues

Finally, there is a range of detailed work remaining to be done on several areas, each of which will be relevant to some members and funds, including:

- Setting out in more detail how the transition from today's system would work, including the status and competitive pressures on any 'legacy' default products,
- Considering in more detail any issues relating to the variation of individual needs or product designs, including:
 - Specific requirements of individuals (eg by occupation or income level, and over the lifecycle);
 - Defined-benefit products and emerging models like collective defined-contribution, both of which may function better when organised through multiple employers.
- Rethinking whether it is really viable to exclude insurance in assessing products. It is probably difficult to justify excluding insurance from the assessment if products still include bundled or optional insurance.

I would be happy to discuss any aspects of this submission with the Commission.