

Response to *Superannuation: Assessing Efficiency and Competitiveness:*  
*Productivity Commission Draft Report, July 2018*

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[http://www.pc.gov.au/\\_data/assets/pdf\\_file/0016/230137/subdr154-superannuation-assessment.pdf](http://www.pc.gov.au/_data/assets/pdf_file/0016/230137/subdr154-superannuation-assessment.pdf)

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### Summary

The Draft Report provides a comprehensive diagnosis, and its proposals offer a significant improvement on current arrangements, particularly the elevated standards for MySuper products. The report proposes to change the default process based on a provided top-ten MySuper list. Workers can choose from the list or from outside the list. Workers who make no choice are allocated to a fund in the list on a ‘cab-rank’ basis. Workers changing employers without declaring a new provider would stay in their existing fund, whether it was a previous choice or resulted from a default.

The top-ten default design would be superior to current practice, but would be riskier for and less supportive of workers than a single default, run by a government agency. This submission sets out two strategic reservations about the analysis in the Draft Report: that it focusses mainly on a snapshot of the default proposal, with less attention to how the system might evolve over time, and that it takes insufficient account of the nature of market equilibrium with frictions and incomplete engagement. Our arguments, set out in section 1, consider consumers, firms and the industry over time.

- Concerns about consumers: in designing default arrangements it is necessary to consider the effect both on workers being defaulted and on workers who make choices. Making a choice and making a choice well are two different things. **Workers who – through lack of knowledge or lack of effort – make bad choices, can also worsen outcomes for other market participants by making higher-price and lower-quality options more profitable for suppliers. Thus a good default can benefit workers in the default and also workers not in the default.**
- Concerns about firms: a firm offering a good MySuper this year will not necessarily still be doing so 20, 30, 40 years hence, as today’s new workers head for retirement. To evaluate the lifetime extent of risk borne by those defaulting under the Draft Report’s proposal, one would need an extensive study of the dynamics of market equilibrium in a system using a periodic listing of top-ten MySupers. Will the same firms stay in the top ten indefinitely? If not, what is the risk to defaulted workers? If so, will the MySuper market evolve to a small number of large firms and a fringe of smaller ones? **If the composition of the top ten changes over time, the risk is that some workers will do poorly and noticeably less well than others; if the composition is fairly static, the risk is that the industry will contract, as in Chile, with a small number of firms making above-normal profits.**
- Concerns about the industry: generally, when demanders vary in how thoroughly they explore the market before making a decision, there are multiple profit-seeking strategies that can be followed by suppliers, resulting in different prices for similar goods and different qualities, particularly of aspects that are not easy to evaluate. Judging the quality of a fund’s investment decisions is not easy. As noted, adding to a market buyers who are less well-informed or less-thorough can make the market work

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less well. **The usefulness of more competition in improving outcomes in markets without widespread informed demand-side engagement should not be overstated. This is clear from the experiences in Australia and elsewhere.**

We therefore stand by the recommendation in our earlier submission of a single government-organised default and, to that end, summarise different ways in which that design can be implemented. We note that individual choice could be influenced by a provided top-ten list without its being used for a default. Section 2 describes two government-run options in use in other countries.

- A government agency could offer a default together with a limited range of curated choices. as is the arrangement in the Premium Pension in Sweden and NEST pensions in the UK.
- Another approach is to limit investments by the government agency to a set of existing privately-provided mutual funds, paying a very low fee for the funds, based on an auction. These funds are then combined in an age-varying way to provide a default. This is the approach of the US Thrift Savings Plan.

Section 3 sets out our responses to the Draft Report's concerns about a government-run default. Section 4 concludes.

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1. The Draft Report provides a thoughtful and wide-ranging diagnosis of the strengths and weaknesses of the superannuation system and contains many policy recommendations that would improve its functioning. In particular, it has identified significant shortcomings in the superannuation accumulation process generally, including the treatment of workers who are placed in a default. Within the system, there is wide diversity in rates of return net of fees, indicating that many workers are not as well served by the system as they might be. This is true broadly, as well as for the workers placed by default. Moreover, comparison of costs with those in defined-contribution plans abroad indicate that Australia does not do as well as some other countries.<sup>3</sup>

2. In a submission after the previous assessment, we proposed a single default for those not choosing a provider, to be run by a government agency. The Draft Report explicitly rejects this proposal and puts forward a new design for the allocation of defaulters to MySuper funds. This submission identifies potential shortcomings in the Report's default proposal and questions some of its arguments against a government-run default. Our conclusions rest on economic analysis and on the experiences in Australia and elsewhere.<sup>4</sup>

3. Section 1 sets out the bases of our critique, including discussion of the economics literature on the nature of market equilibrium over time with frictions and incomplete engagement. These analytics question some of the thinking in the Draft Report about the outcomes from competition and support our view that a government-run default would be superior to the Report's proposed default design. This section also reports some of the history of the Chilean mandatory defined-contribution system, which started in 1981.

4. Section 2 briefly describes some aspects of the government-run defaults in the mandatory defined-contribution plan in Sweden and the voluntary opt-out plan in the UK, both of which approaches seem to us likely to do much better than the current default process in Australia or what we expect would happen under the Report's recommendations.<sup>5</sup>

5. Section 3 offers our response to the Draft Report's concerns about our earlier recommendation of a single default run by a government agency. Section 4 concludes.

6. The Draft Report puts forward five policy proposals affecting workers who end up in a default.

- (1) Require universal participation by employers and employees in an ATO-run service offering an online version of the 'standard choice' form through myGov;
- (2) Publish a list of up to ten 'best in show' funds (as a shorthand, referred to below as a top ten);

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<sup>3</sup> "Nevertheless, asset-class data from other countries suggest fees are significantly higher in Australia. Applying data on international costs to the aggregate asset allocation in Australia suggests total investment fees should be about 0.4 per cent of assets, substantially less than the observed 0.68 per cent." (Page 17.)

<sup>4</sup> We have become aware of the call for the "creation of a publicly administered agency which offered a centrally-administered, passively managed, alternative fund." Nicholas Morris, *The Cost of Complexity: Australian Superannuation*, a thesis in fulfillment of the requirements for the degree of Doctor of Philosophy, UNSW School of Law, September, 2014.

<sup>5</sup> Also discussed is the default in the defined-contribution plan for federal government employees in the US.

- (3) Allocate new workers who make no choice to these top-ten funds in a rotating sequence (cab-rank default);
- (4) Keep workers in the same default when they change employers unless they choose otherwise; and
- (5) Revoke MySuper authorisation from funds that for five or more years persistently underperform by a material margin an investment benchmark tailored to their asset allocation.

In summary, we agree with the significant value of the first recommendation (a mandatory clearing house); we are unsure of the long-run value of (2), periodically publishing a best-in-show list; but, alongside such a list, if legislated, argue for the use of a single default fund run by a government agency, accompanied by limited curated choice, rather than the cab-rank default rule (3); and note problems with default preservation (4) if done in conjunction with the cab-rank default rule (3). Revoking the MySuper authorisation of funds performing poorly (proposal 5), though entirely appropriate and valuable, is not a complete solution to possible declines by a top ten fund previously used as a default.

7. The Draft Report states,

‘In a world of compulsion the onus is on government to ensure that default super is the system exemplar, mitigating the costly (and highly regressive) twin risks for a default member: defaulting more than once or into an underperforming product.’ (Page 32.).

We agree.

## 1 Analysis of the market for pensions

### 1.1 Central issues

8. Financial markets are complex in that the ‘quality’ of a fund (the skill in investing, the prospects of the portion of the worldwide asset market being focused on) is hard to judge and varies from supplier to supplier. Moreover, the degree of success in investment varies over time for individual suppliers. The points are illustrated by the complexity involved in the Commission’s analysis of which funds were doing well. Indeed the Report’s depiction of the wide range of average rates of return over the decade to 2016<sup>6</sup> shows the need to recognise that market pressures in superannuation differ strongly from those in an idealised competitive market. In consequence, overall outcomes differ strongly from those in an idealised competitive market.

9. In particular, as noted in the Draft Report, this observation holds for workers who have been placed in a default.

‘DRAFT FINDING 2.3 There is wide variation in performance in the default segment that is not fully explained by differences in asset allocation. About 1.7 million member

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<sup>6</sup> ‘Overall, the system has delivered mixed investment performance for members. – Over the decade to 2016, both APRA-regulated funds and SMSFs have delivered net returns of about 5.6 per cent a year (although smaller SMSFs delivered significantly less). – Many members are in ‘growth’ and ‘balanced’ products, which delivered around 6.8 per cent a year on average in the 12 years to 2016, beating their tailored benchmarks. – The default segment generated average net returns of about 7 per cent a year over the 12 years to 2016. Top performers were typically (but not always) larger, not-for-profit funds. – For-profit funds as a group, have delivered returns below several benchmarks and significantly below not-for-profit funds. These differences do not appear to be fully explained by fund size, asset allocation or reported administration expenses.’ (Page 91.)

accounts and \$62 billion in assets are in MySuper products that underperformed conservative benchmarks over the 10 years to 2017. This suggests that many members are currently being defaulted into underperforming products and could be doing better. If all members in these underperforming products received the median return from a top-10 MySuper product, they would collectively be \$1.3 billion a year better off. Being in an underperforming product means that, on retirement, a typical worker (starting work today) is projected to have a balance 36 per cent lower (or \$375 000 less to retire with).’ (Page 122.)

10. THE TIME DIMENSION. Beyond the issue of the quality of a default MySuper at the time a worker is assigned to a default fund, there is the quality to be received by the defaulted worker over the rest of his or her working life. The Draft Report’s discussion of four options for the design of a default, starting on page 33, focuses on the immediate impact on newly-defaulted workers without discussion of the time dimension. Under policy (3), workers entering the market for the first time without making a choice would be allocated to a MySuper product that was viewed as being in the top ten at the time of the worker’s entry into the workforce. As these will mainly be young workers, under policy (4), those who continue to make no choice would be in the same plan 40 years later. How much confidence should there be that a top-ten plan in 2020 continues to be as good over the years to 2060? Across the economy generally, many large, successful firms fade over time. If that were to happen to some top-ten MySuper funds, the government would not be taking continuing direct responsibility for people relying on the government to keep them in a good MySuper.

11. PROPOSED SAFEGUARD. The safeguard in the Draft Report is that a plan’s status would be revoked if it was bad enough (policy (5))

‘Funds that fail to meet [the relevant] conditions — or persistently underperform (for five or more years) an investment benchmark tailored to their asset allocation by a material margin, as determined by APRA — should have their MySuper authorisation revoked.’ (Page 59).

‘Where a fund loses MySuper authorisation, members in this product will then need to either actively choose to remain, or otherwise be transferred to a better fund (which must hold MySuper authorisation). APRA will need to oversee this process to ensure remaining members’ interests are protected.’ (p. 465.)

12. The general approach of revoking authorisation from funds that become sufficiently poor for sufficiently long is clearly correct and clearly useful to help workers who chose a fund that has done poorly. However, the process provides only weak support for a defaulter relying on being protected by the government.

- Revocation will generally occur only after five or more years of underperformance.
- Firms doing poorly may pursue investment strategies aimed at avoiding losing their authorisation. This may involve taking on considerable risk, a risk borne by the defaulted workers.
- Anticipating the possibility of revocation a fund family may successfully merge with an ongoing MySuper fund that is not doing as badly, but is not doing well. Moreover, the fund company can also encourage workers to move into their other funds. Thus, the full implications of the risk of a loss of authorisation are not simple to foresee.

- The approach might incentivise a strategy in which a top ten fund seeks to accumulate inattentive workers and to increase fees slowly thereafter – an example of the risk of unintended consequences. Building a reputation and then milking it occurs in many markets.

Thus revocation on its own is not adequate to satisfy an onus on government that ‘default super is the system exemplar.’

13. Nor does the discussion include the impact of the default process on the behaviour over time of profit- and non-profit firms offering superannuation plans. More generally, the Report does not discuss the impact of publication of a top-ten list on outcomes in the superannuation market. Yet, there is an extensive literature on the behaviour over time of mutual fund markets generally, reflecting the behaviour both of investors and of firms. Analyses of information-impacted markets with continuous customer participation (which includes many retail markets) explore the incentives for firms in following diverse strategies in pricing, product design, and advertising. Over time, the evolution of customers with ongoing connections to particular suppliers is also important for the strategies that firms adopt. Thus one cannot merely cite ‘encourage more competition’ as support for a policy proposal. Changes in the regulatory framework of competition will have complex effects, with diverse impacts over time on different demanders and on firm strategies. In particular, it is necessary to consider the effect of different default arrangements both for workers who make no choice and for those who choose among suppliers. The latter are affected by the evolution over time of individual funds and by the overall shape of the industry. Thus workers making choices can be hurt by the industry response to the presence of more workers who are not doing a good job of evaluating their alternatives.

14. The rest of this section considers consumer behaviour (section 1.2) and the behaviour of firms and possible evolutions of the industry (section 1.3).

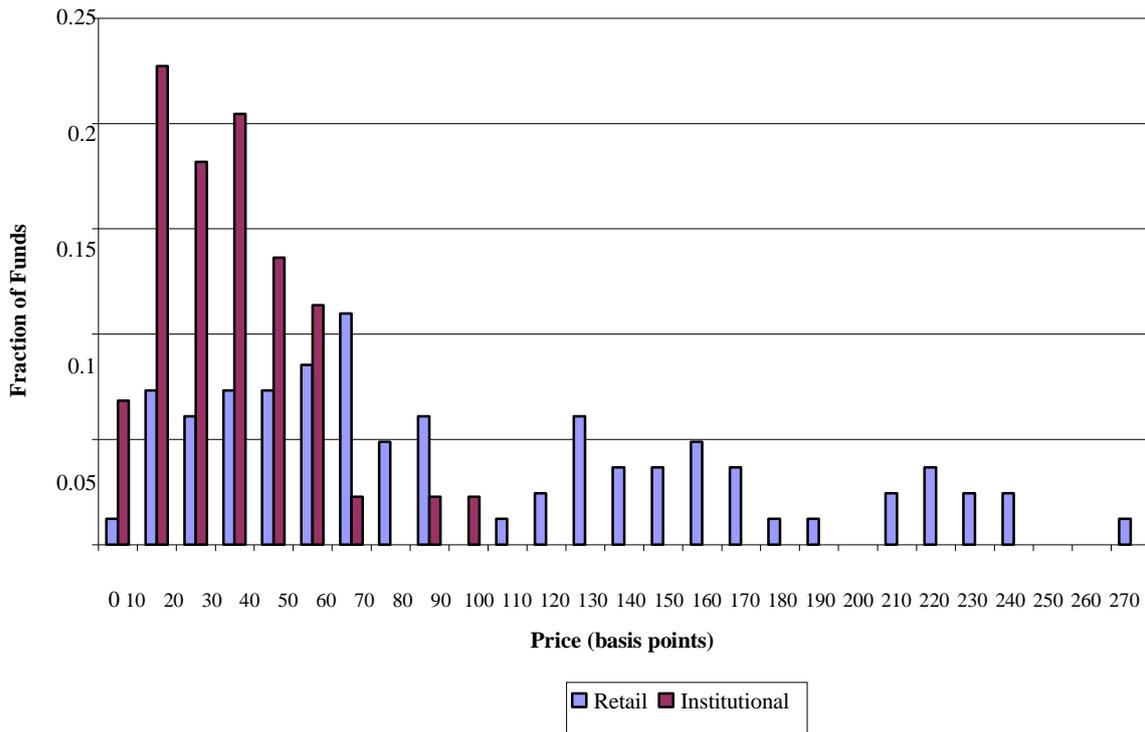
## 1.2 The role of consumer engagement

15. THE ISSUE. Central to our criticism of the Draft Report’s analysis are different perceptions of what to expect from trying to induce more competitive pressure in the market by those tending to default. In particular, though improving some aspects of consumer engagement can be desirable, we regard the emphasis on more competition as overstated. In the textbook picture of a competitive market for a homogeneous good, everyone knows the full range of prices at which the homogeneous good is offered. An implication of this knowledge and the assumption that demanders act on it is the ‘law of one price,’ the conclusion that the homogeneous good will sell at the same price everywhere. Perhaps the type of mutual fund that is closest to a homogeneous product is an index fund for a familiar index. Consider the S&P 500 index funds in the US – a highly developed market with large numbers of investors, many of whom are financially literate and sophisticated. As shown in Figure 1, the charges being made by these funds are very diverse.<sup>7</sup> Diverse charges compound over time to make a big difference in outcomes from saving over a career, as repeatedly (and rightly) discussed in the Report.

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<sup>7</sup> Since 2000, the use of index funds in the US has grown significantly. We are not aware of a study that updates this data, but see no reason to expect a radically different picture.

Figure 1 Retail and Institutional S&P 500 Funds, Price Histograms, 2000



Source: Figure II., Hortacsu, A. & Syverson, C., 2003. Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of the S&P 500 Index Funds.

16. Two sets of questions arise: how many workers will choose and how well will they choose? Getting more workers to choose rather than default may not be helpful.

17. HOW MANY WORKERS WILL CHOOSE? The Commission’s research suggests that many workers will make choices.

... some new workforce entrants will inevitably not make a choice. The Commission’s experimental survey ... suggests relatively few people will fall into this category — with over 95 per cent of respondents who received a recommended shortlist of 4 to 8 funds making a choice; and over 80 per cent of respondents selecting a fund from the shortlist’ (Page 444).

While agreeing that providing a top-ten list is likely to induce more choice, it needs to be recognised that a quantitative inference needs to adjust for the extent to which an experimental setting is different from having access to a list in the midst of the process of entering the labour force or changing jobs.

18. In addition, the continued wide use of a default by new entrants in the differently organised defined-contribution plans in other countries should be noted. In Sweden about 98% of new workers enter the default (Barr 2013, Table 5.1); and in the UK 99% of new members of NEST go into the default arrangement.<sup>8</sup> The Draft Report notes: ‘Up to two-thirds of members default when starting a new job, and about half the accounts in the super system are in MySuper (default) products — representing 24 per cent (\$635 billion) of system assets.’ (Page 25). If this pattern of limited choosing continues, under policy (4), the

<sup>8</sup> *Pers.com.*, 20 October 2016.

system would continue the previous default of these workers into a fund that was top-ten some years ago, and may or may not still be in that category. Perhaps the new system will induce more workers to be engaged but, as discussed below, engagement by those with limited attention to the choice may not have positive effects on equilibrium.

19. HOW WELL WILL WORKERS CHOOSE? Over the last 40 years, there have been many analyses of markets reporting a diversity of prices for similar goods, and developing theories of why that is the case and how the distribution of prices relates to the distribution of customer types.<sup>9</sup> When demanders vary in how thoroughly (in terms both of knowledge and effort) they explore the market before making a purchase, there can be diverse satisfactory profit-seeking strategies to be followed by suppliers using different prices. Moreover, when products can differ in characteristics, diversity in qualities is common as well, including those aspects that are hard for demanders to evaluate. In such a market, adding buyers who are less knowledgeable and/or who make less effort can make the market worse for the set of people already there. This worsening can follow from new demanders who make higher-price and lower-quality options more profitable for suppliers, thereby making more complicated the effort by some people to explore the market. Rather than seeking to increase ‘engagement’ in the market by the workers taking the default, the use of a good default may help others as well as those taking the good default MySuper.

20. This wide deviation from an idealised competitive equilibrium is widespread and remains common even with online markets.

‘...price dispersion is ubiquitous and persistent. Regardless of the particular product (tinplate cans or PDAs), the venue in which they are sold (online or offline, in the US or abroad), or the time period (1901 or 2005).’

‘Despite the widespread adoption of inventions such as the automobile, the telephone, television, and the Internet, price dispersion is still the rule rather than the exception in homogeneous product markets. Reductions in information costs over the past century have neither reduced nor eliminated the levels of price dispersion observed in homogeneous product markets.’<sup>10</sup>

Thus, it is important to examine the details of market outcomes with different regulatory rules rather than simply assuming that more competition makes outcomes better.

21. Studies of the US financial market find that flows into and out of mutual funds are strongly influenced by recent returns. The Draft Report offers no reasons for expecting behaviour in Australia to be different from this pattern. Moreover, the published selection of a top ten is likely to induce shifts among super funds and includes returns in the process of selection.

‘But, given the primacy of net returns to retirement balances (chapter 2), the key focus of the selection process should be on a fund’s **likelihood of producing high net returns for members**. (page 435, emphasis in original).

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<sup>9</sup> See Michael R. Baye, John Morgan, Patrick Scholten. 2006. ‘Information, Search, and Price Dispersion’, in T. Hendershott, ed. *Handbook on Economics and Information Systems*. Elsevier.

<sup>10</sup> Michael R. Baye, John Morgan, Patrick Scholten, *op. cit.* p. 370.

While attention may be to a longer period of history, recent returns are likely to matter as well.

22. IN SUM. It is plausible that the presence of a top ten list would decrease defaulting, without being confident of the exact extent. However, a large increase in the numbers making a choice may or may not be a good outcome.<sup>11</sup> For workers who choose a top ten-fund that does not fit well for their needs, it may not be a good outcome; considerable evidence<sup>12</sup> shows widespread poor financial literacy even in OECD countries; and, as we discuss next, the presence of people making poorly understood choices can influence supply.

### 1.3 Responses by firms and evolution of the industry

23. To evaluate the lifetime extent of risk borne by those defaulting under the Draft Report's proposal, one would need an extensive understanding of the dynamics of market equilibrium in a system using a periodic listing of top-ten MySupers both to allocate defaulters and to inform workers who are considering choosing or reconsidering their super provider. There is also the issue of how the top ten will be presented. Beyond the cab-rank use of the list as a default, the way the list is organised will influence workers choosing a fund, both new entrants and existing covered workers, perhaps particularly when changing employers. Will the list be presented as a ranked order, particularly encouraging choice of the top one or two? Or will there be an attempt to present all ten on equal terms, perhaps by varying the order of presentation in different printed and online publications. Whatever method is used, the order of presentation is likely to affect the evolution of the industry. The Draft Report documents the need for significant changes in the industry, and views revocations of MySuper status as an important source of improvement, a view we share. However, there are likely to be changes over time beyond just the disappearance of some firms and the upgrading of others at risk of losing authorisation. How that evolution of the superannuation industry would vary with the design of the default is important, whether a top-ten list is presented and however it is presented. But the Draft Report does not discuss the evolution of the industry in response to regulatory changes.

24. HOW MIGHT FIRMS RESPOND? The dynamics of firm behaviour in a market with large numbers of demanders with limited attention or understanding illustrates how the presence of such people can influence supply. The literature on US mutual fund markets examines the responses of firms over time to measured movements into and out of funds in response to reports of recent returns. Seeking an increase in the funds invested with them, providers of mutual funds have an incentive to influence demand by the design of their portfolios and by their advertising. Beyond the basic role of sustained decisions in seeking particular risk-

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<sup>11</sup> As one of the witnesses pointed out,

'there's a difference between active engagement and people being interested. A far greater proportion of people are interested in superannuation but don't make active decisions such as changing investment options or changing funds. We found that there was a close relationship between interest and people searching for information, getting onto the website and looking for things. So you don't actually have to be actively doing things to be interested. We have to be careful what we're talking about here with engagement and people being interested (Evidence from Hazel Bateman. Transcript of Proceedings, 20 June 2018, pp. 79-80).

<sup>12</sup> On financial literacy in the USA, see US Federal Research Division (2011), 'Financial Literacy among Retail Investors in the United States', Federal Research Division, Library of Congress, and for international evidence, Annamaria Lusardi and Olivia S. Mitchell (2014), 'The Economic Importance of Financial Literacy: Theory and Evidence.' *Journal of Economic Literature*, 52(1): 5-44.

return combinations, prior to the time of a report on returns, firms with similar basic strategies but different patterns of returns to date have different incentives for taking on risk and do behave differently – funds less confident of having a good report tend to take on more risk than those more confident. It is not clear how different would be the behaviour of providers of superannuation funds from US mutual funds given the difference in regulation, including the need for trustees to be concerned about the workers. But, plausibly, the same pattern will hold, implying that the top-ten process will affect fund risk-taking in anticipation of the selection process.

25. Thus the risk is that over the longer-term, a firm offering a good MySuper this year will not necessarily still be doing so 20, 30, 40 years hence, as today's new workers head for retirement.<sup>13</sup> The extent of decreased quality is somewhat limited by the risk of losing authorisation. As discussed earlier, however, that safeguard may not be as effective as it appears at first glance.

26. If having a top-ten list seems useful, periodic announcements could take place without using the list as the basis for defaults. Such announcements, in pursuit of the Report's goal to 'improve engagement and simplify choice', can be combined with a single government-run default, i.e. the design decouples the top-ten list for workers who wish to choose from the default for workers who make no choice. With the default also available as a choice (as in Sweden), the presence of a government-run default may enhance competition, as appears to be the case with the presence of MySupers offered by nonprofits. Moreover, if experience were to question the value of a sustained top-ten list over the long-run, the presence of a single government-run default would facilitate revisions to the design of any such list.

27. HOW MIGHT THE INDUSTRY EVOLVE? Will all the same firms in the initial top ten stay there indefinitely? If the firms change over time, chosen from a relatively large set of suppliers, the concerns set out above – the operation of markets with large number of poorly-informed or inattentive buyers and limited effectiveness of proposed safeguards – continue to apply. On the other hand, if there is little change in the set of top-ten firms, there is likely to be a major evolution of the industry. Will the MySuper market evolve into a small number of large firms and a fringe of smaller ones? If the latter, how well will competition work? While some shrinkage, focused on the worst performers is to be welcomed, the shrinkage may extend more widely than that, and over time the industry could become dominated by a small number of firms, as happened in Chile, with a small number of firms making above-normal profits. Will the outcomes be as good as they might be? Are the outcomes different with different defaults even if the top ten listing is done the same? We do not have answers to these questions, but regard the top-ten approach as a leap into a new market structure that may well have significant unanticipated effects.

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<sup>13</sup> It might be informative to track MySuper fund performances over time, although the time period with useful data is limited. We note that the Draft Report stated:

'26 of today's MySuper products — that can be tracked back over 10 years — underperformed, and represent 13 per cent (\$62 billion) of MySuper assets and 15 per cent (1.7 million) of member accounts in the sample. There is a material gap between top and bottom performers. – A member entering the system today into the median underperforming MySuper product is projected to retire with 36 per cent less (\$375 000) in retirement than if they entered one in the median top-10 product.' (Page 91.)

28. As a start to considering industry evolution, Box 1 summarises the evolution of competition in the mandatory defined-contribution system in Chile. This may provide insights into how the MySuper industry might evolve despite significant differences between Chile and Australia in initial position and in the details of rules.<sup>14</sup> Lacking an empirical basis for seeing how a system similar to the proposed design has worked elsewhere, it would be good to have plausible theoretical modelling of financial market equilibria over time under such a regime. We are not aware of such modelling.

### Box 1 Experience in Chile

The mandatory defined-contribution plan initiated by Chile in 1981 illustrates our argument that the usefulness of competition in this context should not be overstated. In Chile, each of the available funds has its own default. What is noteworthy is that a system designed to rely on competitive pressures has seen repeated overhauls of the competitive process in light of dissatisfaction with the outcomes, particularly the fees charged by the funds. Moreover, with a target of free entry there was little in the way of regulations to make it difficult for a free-standing financial firm to enter.<sup>15</sup> Nevertheless, there has been significant shrinkage of the number of suppliers – in 1982, when the system rolled out, there were 12 firms. The number rose to 21 in 1994, but there are only 6 firms currently. The rate of return on capital of these providers is above normal.<sup>16</sup> But it is also the case that the fees inside the system appear to be less than those in the open market, presumably a result of the combination of a mandate and a tight regulatory structure.

We note that starting in 2008, Chile introduced an auction mechanism for defaulting new entrants. After a bidding process, a single firm became the supplier of new entrants who made no other choice, with the requirement to use its winning fee structure for all of its current participants.

29. IN SUM. The importance of the intertemporal links based on the behavioural responses of workers and firms undercuts the relevance for the superannuation market of the Report's observation that

'In a competitive system, funds would have an incentive to minimise their costs for a given return and to align their fees with those costs.' (Page 128).

In terms of the government's obligation to mandated workers who do not choose, and so rely on the government to see that they are well treated, we question the appropriateness of an arrangement in which performance can vary across workers who have made no choice and hence are defaulted into one of the top-ten funds and then left there. And we question the value of inducing choice from workers who are not necessarily equipped to do so well.

## 2 Different designs of a default

30. There are different approaches to default (with limited curated choice) that might serve as models for Australia.

- A government agency could offer a default together with a limited range of curated choice. In the Premium Pension in Sweden, a mandatory defined-contribution plan for the entire workforce, the government agency has two underlying safe and risky funds, the risky fund investing in a wide range of types of assets world-wide. The default

<sup>14</sup> See Chile Presidential Advisory Commission on the Pension System (2015), *Report*, (the Bravo Report) for discussion of the evolution of the system (pp. 51-59) and the current performance of pension funds (pp. 72-79).

<sup>15</sup> Other than the fund being a stand-alone enterprise, for example, not a subsidiary of a bank.

<sup>16</sup> Chile Presidential Advisory Commission on the Pension System, *op. cit.*

fund is a lifecycle combination of these two funds. Thus the options for individuals in the Premium Pension are (a) to do nothing and go into the age-appropriate default fund, or (b) choose a combination of the two underlying funds, and/or (c) choose a portfolio including some of the many privately provided funds. As summarised below, a similar approach to default is taken by NEST pensions, an auto-enrolment plan in the UK.

- Another approach is to limit investments by the government agency to a set of existing privately provided mutual funds. These funds would charge the government agency very low fees, based on an auction. These funds are combined in an age-varying way to provide a default. This is the approach of the US Thrift Savings Plan, a defined-contribution plan for US federal government employees. Since the Thrift Savings Plan uses index funds, the difference in fees is the prime difference between funds, unlike managed funds where the choice of allocation across types of assets as well as the degree of success in selections within categories result in additional sources of varying returns.<sup>17</sup>

These approaches differ strongly in the allowed scope of government agency activity and the link to the existing capital market. Which approach is more suitable for a particular country depends on the extent of the willingness to rely on government actions and the likely success of such actions, both of which vary across countries.

31. THE SWEDEN DEFAULT. In the original design, workers who made no choice were placed in the default fund (known as AP7). More recently, workers could choose to have their portfolio with AP7 and were given limited surrounding choice.

32. AP7 organises an Equity Fund and a Fixed Income Fund. Individuals who make no choice go into the default fund, which is made up of the equity and fixed income funds in proportions which vary with age. Up to age 55, 100 per cent is allocated to the equity fund. From age 56 to 75 the allocation is rebalanced annually toward the fixed income fund until reaching an allocation of 2/3 fixed income fund and 1/3 equity fund at the age of 75.

33. Within the AP7 arrangement, workers who wish to do so can choose to invest in a mix of the equity and fixed income funds directly or through three different proportions that are maintained through rebalancing, depending on how much risk they wish to take.

34. Administrative charges are low. In 2016, for the entire Premium Pension, administrative charges were .07% and capital management costs and charges 0.28% excluding annuity insurance administration. Capital management charges by AP7 were less than half of the overall average.<sup>18</sup>

35. THE US THRIFT SAVINGS PLAN. The Thrift Savings Plan has a fund of US government debt and four index funds:

- The G (government securities) fund is based on US government bonds;
- The F (fixed income) fund is based on a broader range of bonds including US corporate bonds and foreign government bonds issued in the US;

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<sup>17</sup> A top ten restricted to a single well-defined index fund would be different from one open to all types of funds.

<sup>18</sup> *Orange Report 2016: Annual Report of the Swedish Pension System*, pp. 38, 40 and 41, and AP7 website.

- The C (commons stocks) fund tracks the stocks in the S&P 500;
- The S (small capitalization) fund tracks the stocks of small and medium size companies;
- The I (international) fund tracks the stocks of large companies in more than 20 developed countries.

In addition

- The L (life-cycle) fund is made up of age-varying combinations of these five funds.

36. An individual can choose a combination of the six funds. An individual who makes no choice is placed in the lifecycle fund targeted at the year that the worker turns 62.<sup>19</sup>

37. The overall costs of the Thrift Savings Plan are very low because it is dealing with a single employer. More relevant for Australia is that the charges paid for the mutual funds that make up its portfolio are very low.

38. NEST PENSIONS IN THE UK. A government agency provides NEST pensions for firms with no other pension plan for their workers. For such firms it is mandatory to offer NEST pensions. The firm's workers are automatically enrolled but can opt out. NEST picks the types of individual funds to be used in the portfolios made available, selecting individual funds from private firms on a competitive basis. NEST offers workers five choices based on the individual funds: target-date, higher-risk, lower risk, ethical and Sharia. A worker who makes no choice is put into the target-date fund aimed at the year in which he/she reaches state pension age.<sup>20</sup>

39. While in Sweden the government agency chooses investment, in the NEST (UK) and TSP (US) defaults, competition by private funds for investments of defaulters is not for individual workers but for the right to manage a portion of the plan's pension savings.

### **3 Response to the Draft Report's concerns about a government-run default**

40. The report argues against a single default<sup>21</sup> on the grounds that:

‘A government monopoly default fund, suggested by some experts, could realise economies of scale within the system and simplify the whole process — but at the cost of abandoning any attempt to both improve engagement and simplify choice. And it would run counter to the (desirable) absence of an actual or implied government guarantee in the

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<sup>19</sup> To be more specific, the G Fund is invested in U.S. Treasury securities with interest based on the market yields of all U.S. Treasury securities with more than 4 years to maturity. The F Fund is invested to track the Bloomberg Barclays U.S. Aggregate Bond Index. The C Fund is invested to track the Standard & Poor's 500 (S&P 500) Stock Index. The S Fund is invested in to track the Dow Jones U.S. Completion Total Stock Market (TSM) Index. The I Fund is invested to track the MSCI EAFE (Europe, Australasia, Far East) Index.

<sup>20</sup> The NEST lifecycle pattern has 3 phases rather than the customary two: a foundation phase, a growth phase, and a consolidation phase. Recognising loss aversion, during the foundation phase (the first 5 or so years) the worker's savings are managed conservatively. Only when there is a solid base does the investment strategy move the portfolio into growth-seeking assets. Thus the design is intended to avoid short-run losses; and the consolidation phase is intended to lock in gains as a worker approaches retirement age.

<sup>21</sup> The issue is discussed in detail in Box 12.7, pages 451-2.

Australian superannuation system and would fail to harness the benefits of a competitive process' (p. 425).

41. **QUALITY OF DEFAULT.** Either a government agency or a top-ten default would be better for many workers than defaulting under the current design. Above, we have spelled out the risks over working life to someone defaulted into a top-ten fund. From the perspective of such a worker, a government-run default with a good portfolio avoids the risks of the evolution of different funds that were in the top ten at different times in the past. A significantly better default may also be chosen by some well-informed workers.<sup>22</sup> The Report raises additional issues about the government-run default beyond this comparison.

42. **IMPROVING ENGAGEMENT AND SIMPLIFYING CHOICE.** It is important to separate (a) issues associated with having a top-ten list and (b) the choice of a default if there is a top-ten list. If there is a strong case to have a best-in-show list, that can be done without its use as a default. The presence of the list would affect engagement and would simplify choice. Given the list, how different the level of engagement and the degree of simplification between a cab-rank default and a government-organized default is unclear and does not seem likely to have large effects. Thus, we do not consider use of a government-run default as 'abandoning any attempt to both improve engagement and simplify choice'. Moreover, as we have argued, expanding engagement and improving engagement are not the same.

43. How the pattern of well- and ill-informed and ill-engaged workers in the active market would be different with different defaults and how that would matter is not simple to evaluate. Whether the effects of having a top-ten list would be better including a cab-rank default or not including that default is again a complex question. Moreover, one would also want to evaluate the impact of the presence of a government-run option on competition in the industry. As to simplifying choice, in total, workers inclined to review their placement in a default should find that review easier when all defaulters are in the same fund than when they are scattered across multiple funds, plausibly more than ten as the top ten varies over time.

44. As well as the ability to fit with a top-ten list, the proposed single default also has the ability to fit with policy for workers in existing default arrangements. Three issues arise.

- The Draft Report wants to address existing multiple accounts coming from multiple defaults. That issue can be addressed in the same way in either the top-ten approach or with a default organised by a government agency.
- The Draft Report recognises some funds that are doing so badly that they may lose their MySuper authorisation. Again, that option is available with both organizational approaches.
- Should previous defaulters be left in plans in which they were defaulted or moved over time into the new default arrangements? A concern is the possibility of instability from too sudden and too large a move. Again, with both organizational approaches, there are options to move people slowly from some of the plans, or do nothing further.

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<sup>22</sup> At the start of the Premium Pension in Sweden, the only way to be in the default was by not returning the form selecting a portfolio. Some sophisticated investors, viewing the default as best, did not return the form. Later, the regulations allowed people to choose one of the options provided by the government agency providing the default.

45. **IMPLICIT GUARANTEES.** It may be argued that a single default might be regarded as having an implicit guarantee. Indeed, the possibility of political pressure to address concerns about outcomes is always present. Since we are not knowledgeable about Australian politics, we merely want to identify that the extent of political pressure will depend on the context.

- Would there be a call for a response if it was discovered that some of the default (or chosen) plans were frauds which left workers with no funds? Issues reflecting government regulatory failure with different degrees of relative impact across workers may have different degrees of salience.
- Presumably an extended period of low returns globally would be viewed with regret, but would not call for the same sort of response (although some policy changes might be appropriate).
- An arrangement with multiple default funds faces the risk that people with similar earnings records experience very different outcomes. That risk arises both where a worker has been allocated to a default and where he/she has made a choice from the top 10. If outcomes vary significantly might this call for a response?

The government has mandated participation. A top-10 ranking is an explicit recommendation, a default fund is an implicit recommendation. In some circumstances, there will be pressure on government to offset major harm from the government's mandate and government regulation, whether the government runs a default or not.

46. **QUALITY OF GOVERNMENT INVESTMENT.** The report raises concerns about how well the government would do in running a default. There is widespread awareness of underfunding of government defined-benefit plans for public employees notwithstanding the intention that the plan should be fully funded.<sup>23</sup> As MySuper is a defined-contribution plan, underfunding is not an issue, although the quality of investment must be considered. Some countries invest well through funds run by a government-agency, such as that for the defined-benefit Canada Pension Plan and the default for the Swedish Premium Pension. Yet it is common to see poor investments, for example with requirements to hold excessive amounts of government debt to address fiscal concerns. This concern can arise with government-run funds and with privately-run pensions, which can be mandated to hold government debt, as, for example, in Argentina and Hungary. Similarly excessive encouragement to invest domestically can arise in both government-run plans and mandates to privately-run plans. The approach of having a government agency use private investment firms as in the United States and the United Kingdom can limit some of those political pressures. Whether the quality of government in Australia is better suited to direct investment for the default (with or without reliance on purchased private funds), or to regulation of private investment in defaults is a question for the Productivity Commission, not us.

## 4 Conclusion

47. The Draft Report provides a comprehensive diagnosis, and its proposals offer a significant improvement on current arrangements, particularly the elevated standards for MySuper products.

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<sup>23</sup> This is separate from national plans, like the Age Pension, which were not designed to be fully funded.

48. The specific arrangement for defaults, cab-rank allocation to the funds on the top-ten list, however, risks being unfair to defaulted workers and is not helpful for efficiency. In designing default arrangements it is necessary to consider the effect both on workers being defaulted and on workers who make choices. It is necessary also to consider the behaviour over time of firms and the evolution of the industry. Our main arguments are fourfold.

- Making a choice and making a good choice are two different things.
- Workers who – through lack of knowledge or lack of effort – make bad choices, can also worsen outcomes for other market participants; thus a good default can benefit workers in the default and also workers not in the default.
- The usefulness of competition in improving outcomes in markets without widespread informed demand-side engagement should not be overstated. This is clear from the experiences in Australia and elsewhere.
- If the composition of the top ten changes over time, the risk is that some workers will do noticeably less well than others; if the composition is fairly static, the risk is that the industry will contract, as in Chile, with a small number of firms making above-normal profits.

49. For these reasons,

- We continue to favour the use of a government-organised default with curated choice, and with funds managed either in house (as in Sweden), or with different parts of the portfolio provided by private firms selected through competition, as in the US Thrift Savings Plan and NEST,
- A combination of a government-organised default with a top-ten list would offer flexibility for any future adjustment of the design or operation of the list.
- In contrast, we view the use of a cab-rank top-ten default as a more risky design for the future of superannuation. We think it is important to acknowledge the government's obligation, as stated in the Draft Report:

‘In view of the compulsory and complex nature of superannuation, default arrangements reflect the duty of government to ensure the interests of these employees are protected.’ (Page 426).

‘Government's duty to protect members is of heightened importance in a defined contribution system where most financial risks lie with the individual: in relation to investment performance, fees and ultimately the benefit in retirement.’ (Page 456).