Mission Impossible

Why the proposed CIPR framework cannot deliver the incomes retirees deserve

DEVELOPMENT OF THE CIPR FRAMEWORK

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Industry Super Australia

ABOUT INDUSTRY SUPER AUSTRALIA

Industry Super Australia (ISA) is an umbrella organisation for the industry super movement. ISA manages collective projects on behalf of a number of Industry SuperFunds with the objective of maximising the retirement savings of five million industry super members. Please direct questions and comments to:

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KEY POINTS

1. Australia has a very good retirement savings system. It has a strong foundation of compulsory contributions supplemented by industrial instruments. The long term average net returns on contributions into the system are higher than the OECD average. However this is due to the high average net performance of industry super funds and other funds that are run only to benefit members, jointly governed by employer and employee representatives, and distributed through the workplace. Without the industrial part of the superannuation system, the Australian system would perform worse than the OECD average - and be held in lower regard worldwide.

2. Today policymakers have an important opportunity to transition the retirement savings system into a world-class retirement income system. To do so, policy makers will need to draw upon evidence of what already works well in Australia, and how the best pension systems in the world are organised. We know from decades of experience in this country and around the world what does and what does not work in the interests of superannuation members. An evidence-based approach can reduce the risk of reproducing the mistakes of the past, and help develop a retirement income system that puts the interests of beneficiaries first.

3. An empirical assessment of superannuation in this country yields certain key facts about what has worked and how members actually engage with the system. These include the following:

- Superannuation is an instrument of social policy that exists to improve the wellbeing of retirees. How it performs will have important long-term implications for our collective social welfare. As a result, policy must do more than simply mandate savings: it must connect savings to the best providers, regulate these providers to ensure their structure and operation delivers efficient and faithful service to members, and ensure that the form of benefit provided to members is consistent with social policy objectives. Policy cannot be indifferent to which funds and future retirement income products millions of employees become members of.

- Compulsory savings has been an unequivocal success. But the policy settings that connect these savings to providers have been in flux, resulting in a “social experiment” of retailisation in super. Under this experiment, some members join funds that are part of the “industrial system” and other members join funds that are for-profit retail offerings. The evidence about this experiment is now clear.

    - On the supply side, there is no doubt that for-profit providers of superannuation services (whether trustee or self-managed) regularly prioritise their interests over the interests of members. This is clear from the lower average performance of for-profit funds and SMSFs, the propensity to retain related parties at above market rates, and the many culture-driven scandals in wealth management.

    - On the demand side, members are not equipped to make choices that are in their best long-term interests. Levels of member engagement and information are low, and will very likely remain so. Individuals cannot realistically obtain and digest all the material and relevant information on an ongoing basis to make continuous informed decisions. Strong cognitive biases are ever-present. As a result, the evidence is clear that when members do make independent choices, those choices result in poorer financial outcomes. Even when members who regard themselves as financially literate make choices, such as deciding to establish an SMSF, the average outcomes are poorer.

    - The retail system is highly inefficient. Efforts to address the conflicts of interest of providers and the information asymmetry of members consumes substantial private resources to

operate (preparation of disclosure, preparation of advice, review of disclosure and product/provider options, and ongoing monitoring of each by every member), and consumes substantial public resources to regulate, monitor, and police.

    - The lesson for policy makers is that relying on a retail mechanism to (i) connect members to providers and products, and (ii) ensure that products are developed in the interest of members consistent with the social policy objectives of the system has not worked.

- While deregulation has ushered in a retail system in super, the traditional "industrial system" of superannuation has continued to operate alongside the retail system. Australia's industrial superannuation system shares many features in common with the best retirement income systems in the world such as Netherlands and Denmark. These features include: (i) the funds are run only to benefit members (i.e. operate on a not-for-profit basis), (ii) members are connected to providers and products through low-cost workplace distribution, selected by collective industrial instrument or enterprise agreement, and (iii) funds are governed by representatives of employees and employers. Unlike the retail system, the industrial system has been effective, delivering higher long term average performance and very low levels of misconduct.

- Australia's industrial system for superannuation differs from those in Netherlands, Denmark, and other highly regarded private retirement income systems in one key way: in Australia, the form of the benefit established by public policy is an account or "pot of money", whereas in mature retirement income systems the form of benefit is a retirement income with certain key features: (i) the retirement income lasts for life, (ii) it is reasonably predictable as the member approaches retirement so they can plan, and (iii) it is reasonably stable regardless of short term financial market conditions such that it can be relied upon by members.

- There is no evidence that the central assumption of the Discussion Paper, namely that increasing the number of retirement income product choices available to members will improve outcomes, is accurate. The evidence from superannuation in accumulation is that a proliferation of product and investment choices is associated with inefficiency in the form of poor performance by those funds that offer them.

- An evidence-based approach should seek to learn from what already works well in Australia and what makes the best pension systems overseas work so well for retirees there.

4. The proposed CIPR framework does not reflect the evidence. It does not build on what has been proven to work in the best interests of the large majority of Australian fund members. In particular, the CIPRs framework:

- Forces choice on new retirees, exposing them to retail marketing pressures and the risk of making poor choices at a critical moment in their financial lives.

- Assumes a capacity for rational choices by new retirees, and a benignness on the part of providers, for which there is no evidence. The evidence is that members lack the capacity to make good choices throughout accumulation and retirement, and that for-profit providers often do not act in the interests of members.

- Risks reproducing the underperformance of existing retail retirement income products, and their related for-profit business behaviours, within the envisaged CIPR framework.

- Embeds life office annuity products into our retirement income system that are intrinsically income-inefficient because of their conservative asset base and the cost of delivering returns to capital providers.

- Will generate additional leakage from the superannuation system because retirees will have to make much greater use of personal financial advice in order to understand how their particular product choice will interact with complex tax and social security regulations.

- Will be inefficient, raising individual costs and system costs in an effort to address the conflicts of interest of providers and the information asymmetry and cognitive limitations of members.

5. There is a better way to transition superannuation from a system focused on accumulation to a retirement income system, one based on strong regulation not retail market forces, and one that builds on what already works in Australia and in the best retirement income systems in the world. The key elements of this approach include:

- A policy framework that explicitly recognises the social policy purpose of superannuation, understands that most members are not persistently engaged, dispassionate financial experts, and so focuses on applying a public interest quality filter that connects employees to the best quality funds.

- Recognising the industrial status of super, the cost-efficient nature of workplace distribution, and the independence of the industrial relations system from the financial sector, the selection of the best quality funds should be undertaken by the industrial representatives of employees and employers in the context of agreeing modern awards and enterprise agreements, under the jurisdiction of the Fair Work Commission. This recognises the proven ability of our industrial relations system to allocate employees to good and industrially-relevant funds.

- Members allocated to the best funds should be defaulted into whole-of-life products that provide a "member experience" similar to a defined benefit plan. This means the products should focus on efficiently delivering retirement income that lasts for life, is reasonably predictable, and is reasonably stable. They should offer a seamless transition into retirement which involves no point of sale and in which the member makes simple elections about their *benefits* (e.g., the level of commutation and whether to seek a spousal reversionary pension) rather than *products*. The priority should be on delivering the highest and most stable income possible, on the basis of which members will have a greater freedom to make individual consumption choices.

- While the "member experience" should be similar to a defined benefit plan, the specific products or structures that trustees use to deliver that experience will be the subject of ongoing innovation. Subject to such innovation and trustee discretion, the longevity of retirement incomes could be underpinned by pooling in the form of an open Group Self Annuity or a Collective Defined Contribution plan, both of which efficiently deliver retirement income for life and eliminate value-leakage to third parties such as life offices.

The transition of superannuation from a system focused on accumulation to a system focused on delivering retirement income is an inflection point in the evolution of the system. The transition can proceed in one of two ways. It can continue the trend toward retailisation and product proliferation, by using retail mechanisms to shift the form of benefit to a retirement income stream. This is the approach that is of interest to the financial services sector. Or the transition can build upon the industrial system, which is the best performing part of the superannuation system, and the approach that is employed in the best performing systems around the world.

1. Introduction

Industry Super Australia (ISA) welcomes the opportunity to respond to the Discussion Paper and to help inform public discussion of how Australia should best transition from a superannuation system focused on accumulation to one focused on delivering retirement income.

The division between accumulation and retirement phases in the Australian superannuation system has always been an artificial one, a product of the distinctive nature of how the system has emerged and evolved over the past 30 years rather than of rational policy design. A true retirement income system does not have separate accumulation and retirement products: it has the single aim of providing a reasonably predictable and stable retirement income that retains its purchasing power, for the whole of a retiree's life. The provision and design of products should be geared toward this end.

We therefore welcome the increased focus among policymakers on how the superannuation system should provide retirement incomes. However, effective reform that is in the long-term interest of members and the public will require keeping certain matters front-of-mind:

- Superannuation is not just another financial product to be bought and sold, akin to a credit card or a car loan. Superannuation is an instrument of social policy. Campaigning by unions in the 1970s and 1980s, which was supported by a growing number of employers and followed by the Superannuation Guarantee in 1992, sought to ensure future retirees would have higher living standards in retirement than if they relied solely on the Age Pension. So our system of superannuation exists for a collective social purpose, and how it is designed and performs will have long-term implications for nearly all future retirees and taxpayers – and the fiscal position of future governments. This is important because it means that the superannuation system, when it emerges from this transition to a retirement income system, has to first and foremost deliver on its social policy purpose as efficiently as possible.

- The policy architecture of a savings-based retirement income system involves addressing four key territories: (i) getting savings in the system, (ii) connecting those savings to the right providers who (iii) provide the right form of benefits consistent with the system's objectives, while (iv) facilitating a useful role for those savings in the economy and avoiding harm such as systemic risk. Savings are delivered into the superannuation system due to compulsion, a very strong foundation. Yet transitioning superannuation from an accumulation focused system to a system focused on retirement income will involve further efforts in connection with (ii) and (iii).

  Savings are most effectively connected to the right providers through the industrial system, where employer default funds are determined by modern awards or enterprise bargaining agreements. However due to deregulation pushed by the finance industry, a poor-performing and inefficient retail market system sits side-by-side with the industrial system. The employer default system currently provides for accumulation-only products. So a straightforward change to the Fair Work Commission modern award process, to provide that the employer default should be a whole-of-life product that delivers retirement income, would achieve the policy aims of the Discussion Paper.

- Employers and employees are compelled by law to participate in the superannuation system. There are good reasons why this should be the case. In the absence of compulsion, citizens would undersave. But a consequence of compulsion in our system is that employees, regardless of their levels of engagement and understanding of superannuation, must make contributions to privately-owned and operated organisations.

There is a large body of empirical evidence that shows most members of superannuation funds are not well equipped to make informed choices that are in their best long-term financial interests. This is the case whether or not they are engaged and sophisticated. Moreover, whatever capacities they do have tend to decline with age. This is the case in Australia and in every other country where the financial literacy of their populations has been assessed. Despite periodic efforts by governments in Australia and abroad to increase financial literacy, levels of understanding have remained persistently low. All the evidence is that this is very likely to remain the case. One consequence of this is that levels of active and informed engagement with superannuation are low and will very likely remain so. Even when consumers do engage, they face information asymmetry, operate under cognitive biases, and face providers who use sophisticated marketing techniques to shape their decisions.

Moreover, consumers do not, and cannot reasonably be expected to continuously monitor their providers, products, indirect investments, and the host of other information that would be necessary for competition or consumer demand to deliver good outcomes. Consumer-led competition has very little relevance to how most employees interact with superannuation and to how the dynamics of the system will operate in the foreseeable future. Policy reforms that aim to change how members experience and benefit from superannuation must recognise this key fact.

- The superannuation industry comprises two main ecosystems, each of which have important implications for how members are viewed and the behaviour of providers. The 'retail ecosystem' comprises funds that have been established by corporate parents for the purposes of generating revenue and profits for shareholders. As such, these funds tend to prioritise the sourcing of products and services from other companies within the same group, often transacting on a non-arms-length basis as a means of generating additional profit for those related companies.

  In contrast, the 'industrial ecosystem' comprises funds that have on average been able to routinely outperform retail funds because (i) they return all profits to members, (ii) utilise a low-cost workplace distribution model for most of their products, (iii) are selected by collective industrial agreement, and (iv) are governed by representatives of employees and employers whose first and only duty is to fund members.

  The industrial ecosystem is not unique to Australia. More developed forms of the system exist in a number of countries that have the best performing pension systems in the world such as Denmark and the Netherlands. What distinguishes Australia from these world-beating systems is that our industrial ecosystem exists alongside an underperforming retail sector that extracts value from some members because we allow our retirement income system to be used as a source of economic rent.

  It will be argued in this submission that we can combine the great strengths of Australia's system, including compulsory savings, near universality, and leading asset allocation, with the world's best pension systems partly by offering a whole-of-life retirement income product that is designed only to benefit members.

- The key manifestation of the difference between the retail and industrial ecosystems is that ever since APRA started publishing performance data not-for-profit funds have, on average, delivered higher long-term net returns to members than for-profit funds. Analysis of APRA data shows this outperformance has averaged around 1.5 per cent per year over the past 10 years.

  But the difference also manifests itself in other ways that are sometimes less obvious to regulators and policymakers. Because members of retail funds are regarded primarily as sources of revenue and potential profit, they come under routine marketing pressure to buy additional financial

products (known as 'cross-selling') or to switch into other superannuation products because such products are more profitable for those who operate the funds (known as 'up-selling'). These funds also engage in non-net return forms of selling such as confusion-marketing.[1]

How retail funds are driven by their business model to behave is important to understanding how such funds are likely to design, frame and communicate the options available to newly retired members, including those options that relate directly or indirectly to a CIPR.

- Consistent with the social policy objective of mandated superannuation, the priority for policymakers should be to reform the system in a manner that delivers the most efficient and stable income for life. The Discussion Paper makes a number of references to the importance of facilitating freedom and choice. However, we know from over 20 years' experience that the choice-emphasis in policy and regulation has not delivered better outcomes for most members. It has increased system costs and increased the risk that low-information members are allocated to poor performing products.

  In a context where power in the market for superannuation resides overwhelmingly with providers, the focus for policymakers must be on enabling individuals to express their particular preferences on the basis of the most efficient and stable income that policy-settings can provide. In this context 'freedom' means not the freedom to be sold into poor quality financial products, but instead the greater capacity to express individual preferences in the market for real goods and services that having a higher retirement income provides.

The preceding matters have important implications for the role that government and regulation should play in our superannuation system – before and during retirement. Given that (i) superannuation exists for a social policy purpose, (ii) employees are compelled by law to participate in a system many do not understand, and (iii) some funds exist primarily for the purposes of generating profits for non-members, government has a special responsibility to act to ensure that employees and retirees are connected to good quality products and funds that do not seek to exploit their age, their low levels of financial literacy, and their consequent vulnerability to marketing pressures.

We will return to these matters, and relevant supporting evidence, in the context of our discussion of the proposed CIPR framework. We respond to a selection of questions posed by the Discussion Paper in Appendix A.

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[1] 'Confusion marketing' is now a common strategy in financial services, and retail banking in particular, where an excess of opaque and complex information is provided to consumers with the aim of encouraging the purchase of products that are most profitable to the provider, not those necessarily of greatest financial benefit to the customer. The use of confusion marketing in retail banking is discussed in Bowman, A. et al (2014) The end of the experiment? From competition to the foundational economy, Manchester University Press.

2. The Discussion Paper's Approach

In the Discussion Paper the principal problem afflicting the retirement income system is defined as the lack of choice retirees face when they reach retirement. One symptom of this lack of choice is a heavy reliance on Account Based Pensions (ABPs) and the consequent downward pressure on living standards that arises from retirees self-insuring against longevity risk by under-spending their ABP assets.

The Discussion Paper argues that a solution to this problem is to offer a greater choice of products that pool longevity risk. The role of a CIPR is to simplify the choice-event by offering a product that is appropriate to the majority of fund members, effectively nudging members toward a CIPR if they do not wish to engage in other decisions.

However, it will be possible to tailor a CIPR on an individual basis, with the result that the simplification nominally offered by the CIPR framework will potentially, in practice, entail a set of complex longevity/liquidity decisions that can be used by some providers to disadvantage individual retirees and that individual retirees cannot be reasonably expected to navigate. So while the Discussion Paper sometimes couches CIPRs in terms of them 'easing' the retirement income decision, in practice even those retirees who remain within the formal CIPR framework may be confronted with a set of highly complex financial decisions.

In short, retirees must choose. The Discussion Paper argues that forcing choice will have three related beneficial consequences.

Firstly, it will 'facilitate engagement.' The assumption here is that members of superannuation funds do not engage with super because of a lack of products. However, retail funds already offer thousands of differently branded products and options in the accumulation and retirement phases, the availability of which has not generated heightened levels of financial literacy and informed engagement. This helps to explain why retail funds hold a higher proportion of inactive accounts than those held by industry funds.

Secondly, it will help to ensure that the retirement income products chosen are in the best interests of the individuals who choose them. The assumption here is that most members of superannuation funds who are approaching retirement have the capacity and resources, in the face of marketing pressures and sales-driven advice, to make rational decisions about which CIPR or non-CIPR product is in their best long-term interests. The evidence says otherwise: members approaching retirement are exposed to significant 'behavioural risks.'

Thirdly, it will increase competitive pressures to offer yet more product choices, reduce prices and improve retirement incomes for retirees. The assumption here is that competitive processes, driven by engaged and informed choices by individuals, will benefit members. Given the imbalance in knowledge, understanding and resources between members and providers, there is no reason to believe that competition will act in the way assumed in the Discussion Paper, and so no reason to assume any of the alleged benefits will materialise.

In sum, the worldview adopted by the Discussion Paper is one that has been repeatedly rejected by experience.

It is no longer credible to develop policy on assumptions of rational, informed consumers, each with their own unique preferences, who are only prevented from shaping the superannuation industry to their benefit by a lack of products to choose from. Such policy assumes a degree of potential decision-making autonomy and rationality on the part of most fund members which is contradicted by real-world experience. It assumes that providers merely respond to expressed consumer preferences, with no attempt to shape those preferences or game the outcomes to the benefit of their owners and shareholders.

In 2010 the final report of the Cooper Review into the superannuation industry reflected on the worldview that had been adopted by the Wallis Report in 1997. It concluded:

> 'A key tenet of the 1997 Wallis Report was that super fund members should be treated as rational and informed investors, with disclosure and market conduct controls being the main regulatory instruments with which to oversee the industry.
>
> More specifically, these settings assume that members have the tools at their disposal, and the necessary regulatory protections in the market place, to enable them to make optimal decisions about their investment strategies, about when to enter and exit the market, and about what to do with their super on reaching retirement. In a compulsory system, it also assumes that members have the requisite degree of interest.
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> But, for many members, this is not the case.'[2]

The Cooper Review reached this view after drawing on the real-world experience of the superannuation industry since the early 1990s and the conclusions of behavioural finance research. Unfortunately the current Discussion Paper does not engage with these conclusions and their implications for how we should approach improving retirement incomes.

A better approach to transitioning superannuation into a retirement income system should start with what the social policy objective ought to be, and the sought-after member experience within the system. Such an approach should involve:

- Understanding superannuation as an aspect of social policy, the regulation of which must prioritise connecting members to the best providers who seek to maximise benefits to members.

  By maximising reliable retirement income, members can then best express their individual preferences for consumption in the market for real goods and services because they have higher income for every dollar of contribution they have made over time.

- The default product in the superannuation system should be a whole-of-life retirement income product, with seamless transition into retirement income similar to the experience of members in a defined benefit plan. There would be no point-of-sale or need to require a complex decision to join a retirement income product when employees retire.

- The default product should be distributed under the aegis of the industrial system's default safety, to ensure that every dollar contributed by members, by employers, and by the government is most efficiently converted into reasonably predictable and stable retirement income that last for as long as the retiree lives.

This is a different approach to that taken in the Discussion Paper. It starts from the recognition that in a mandated system where employees are compelled by law to engage with a superannuation system many do not understand, it is necessary for government to provide a default safety net for those who cannot or do not wish to make a choice. Members are entitled to expect that government acts to safeguard their interests – not force them to navigate a highly complex and confusing financial universe in which some providers exist solely to make profit for others.

In short, non-choice is an entirely legitimate stance for employees to take – it is not a problem to be solved.

[2] Super System Review Final Report, p. 8

Before outlining our recommended approach in more detail, we will discuss our concerns with the Discussion Paper's approach under two headings: 'Problems of Inefficiency' and 'Problems of Choice and Member Protection.'

3. Problems of Inefficiency

Improving the efficiency of how the superannuation system delivers incomes to retirees is important, and there is scope to do so.

When the superannuation system transitions into a retirement income system, the primary indicator of efficiency should be the extent to which each dollar of contributions made by fund members during their working lives results in a greater dollar amount received by those members when they retire in the form of reasonably predictable and stable retirement income that is payable for as long as the retiree lives. One dollar of contributions that results in two dollars of such income is clearly less efficient than one dollar resulting in three. The task for policymakers is to work to secure the latter outcome in place of the former.

The Discussion Paper addresses inefficiency – but only in the context of identifying unspent super and bequests as a reason why retirement incomes are lower than they would be if drawdowns from ABPs were more evenly spread across the retirement phase.

While this is true, the policy tool being used in the Discussion Paper (i.e., a "nudge" after a member has decades of engagement with superannuation as an "account" entitlement rather than an income stream) is not likely to be strong enough to overcome the forces that drive this inefficiency. The evidence suggests that much unspent superannuation at death is the intended result of a mix of precautionary and bequest motives, and that these motives remain strong among current fund members approaching and during retirement. While there may be scope for attempting to nudge some retirees into making greater use of their ABPs to increase their living standards, many members are currently retiring with balances that are unlikely to generate an annuity-based income of sufficient value to dilute their precautionary and bequest concerns.[3]

An additional problem with the Discussion Paper's focus on residual capital is that there are a number of important inefficiencies within the present superannuation system, and in the suggested CIPR framework, that have a stronger effect on the level of retirement income received by retirees. These relate to the likely value to members of life office annuities, variations in ABP performance, the inefficiency of retail distribution (which is central to the Discussion Paper's framework), and the costs to members of the for-profit business model in superannuation. We discuss each in turn.

3.1 Problems with Immediate and Deferred Life Annuities

The Discussion Paper states that the CIPR framework is not intended to promote annuities over other longevity products, and the three models proposed in the Paper do not specify annuities in the context of how a CIPR may necessarily manage longevity risk. However, in practice, there has been an emerging trend for some funds to utilise these products as part of their retirement income offering. In particular, those funds that form part of a corporate group that includes for-profit insurance provision are likely to prefer life

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[3] The average retirement balance of members varies considerably between superannuation funds. While ABS figures indicate that the average retirement balance across the population (male and female combined) is currently $215,000 (and much lower for women at $138,000), the average for all members of one large industry fund that mainly serves low-income occupations is currently around $130,000. Invested on a 50 per cent basis, an immediate life-time annuity purchased for $65,000 may generate a CPI-indexed annual income of perhaps $3,000 per year – or $250 per month (these are notional calculations based on what some available annuity products presently offer).

and deferred annuities because an important source of profit for the corporate parent is the payment of relatively high fees for products and services provided by related entities, such as insurers.[4]

Furthermore, evidence from the UK suggests that annuity sales to members of pension schemes by related insurance entities (so-called 'retention business') has been an important source of profitability because it is easier to leverage information-asymmetries and customer inertia in the context of already existing client-business relationships.[5]

Currently, life office annuities have several structural features that render them intrinsically inefficient as a source of retirement income. The income to members delivered by the underlying asset base will always be relatively low because providers have an interest in minimising their risk exposure and delivering a return to the providers of capital. This is compounded by regulation which demands a conservative asset profile commensurate to the hard-promise nature of annuity contracts and the need to mitigate counter-party risk. Further, the intrinsic inefficiencies of life annuities are exacerbated by the current low interest rate environment.[6]

The poor value offered by immediate life annuities has been illustrated by Rice Warner. Their modelling for the Financial System Inquiry showed that an ABP drawn down to generate an income equivalent to a fully invested immediate life annuity would, in the median case, maintain the annuity-equivalent income and the initial capital sum until maximum life expectancy.[7]

While deferred life annuities (DLAs) are being strongly promoted by some in the financial industry, there is evidence from the Australian Government Actuary that when combined with an ABP they can generate even less retirement income than an immediate life product.[8] Stochastic modelling of an ABP/DLA combination of 77 per cent/23 per cent, with the DLA commencing at age 85, produced an expected retirement income from the DLA that was lower than the life product because of the impact of pre-85 mortality.

There are two alternatives to life office annuities that, if delivered within the protections of the industrial system's quality filter, are likely to more efficiently deliver the social policy aims of the retirement income system:

- Group self-annuitisation (GSA): While GSAs do not offer a hard-promise akin to life office annuities, they offer some potential advantages in an industrial system context. They do not require capital backing, they can be offered directly by a superannuation fund without having to pay an external provider, and their collective income-efficiency is high (particularly so in an industrial system context where there is no business imperative to extract value from members in the form of high

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[4] See Liu, K. and Bruce R Arnold, 'Australian Superannuation Outsourcing – Fees, Related Parties and Concentrated Markets', APRA Working Paper, 12 July 2010, p 2; see also Ellis, K., Alan Tobin and Belinda Tracey, 'Investment Performance, Asset Allocation, and Expenses of Large Superannuation Funds', APRA Working Paper, October 2008.

[5] Financial Conduct Authority (2014) Thematic Review of Annuities, TR14/2, London.

[6] There may be a role for life office annuities in a Pillar 3 choice environment for those retirees who want a hard-guaranteed income, and who expressly choose to pay the associated costs. The poor cost/income ratio for annuities makes them unsuitable in a Pillar 2 context where the priority should be to maximise income-efficiency as central to its social policy role.

[7] See Rice Warner (2014) Retirement Income Solutions: submission to the Financial System Inquiry, p. 17.

[8] See Australian Government Actuary (2014) Towards more efficient retirement income products, paper for the Financial System Inquiry.

distribution and third-party profit costs). An open GSA pool also has the potential to substantially reduce the risk that incomes will not be paid to those who live beyond their formal life expectancy.

Modelling by the Australian Government Actuary found that a GSA can deliver retirement income levels 40 per cent higher than an ABP drawn down at minimum rates. Further, unlike drawing-down an account-based pension at a faster rate, the GSA delivers a higher income without any increase in the risk of outliving savings.[9]

- Collective Defined Contribution (CDC) plans: CDCs combine longevity risk pooling and intergenerational investment risk sharing to target a future whole-of-life pension income that has the potential to not only last for life, but also to be higher and more stable than alternative structures because the ups and downs of investment experience can be shared between cohorts of working and retired members. A CDC plan can retain a long-run allocation to growth assets, and the associated net return benefits, that annuities cannot.

  Modelling by the Pensions Policy Institute (UK), Aon Hewitt and the UK government actuary all found that variously designed CDC plans deliver higher and more stable retirement incomes than structures that did not involve risk sharing and risk pooling.[10]

However, innovation in retirement income delivery continues and trustees may have different approaches to product design in light of their particular demographics, member balance profiles and financial flows. As a result, it would not be appropriate for government to mandate a specific approach to product design as part of the CIPR endeavour.

3.2 ABPs in the CIPR Framework

It appears from the Discussion Paper that an ABP, as the main source of liquidity and flexibility, is likely to play an important role in shaping the total value of income that members of each CIPR will receive. We note the recently published paper from the Australian Government Actuary which offers a preliminary view of how the income efficiency of a CIPR could be tested for the purposes of actuarial certification and the potential role of an ABP in that process.[11]

How an ABP is tested in the CIPR framework is important because it is being proposed that to qualify as a CIPR a retirement income product must deliver a level of income greater than that provided by an ABP withdrawn at minimum rates.

In a context where it is envisaged that CIPRs are sold directly to members without a public interest quality filter, in the absence of measures that set a consistently high performance bar for any product that wishes to be granted CIPR status there is a risk that poor performance and reduced retirement incomes will become embedded into our retirement income system.

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[9] Ibid, p. 22.

[10] See: Pensions Policy Institute (2015) Modelling Collective Defined Contribution Schemes, London; Aon Hewitt (2013) The Case for Collective DC, London; Department for Work and Pensions (2009) Modelling Collective Defined Contribution Schemes: a summary of The Government Actuary's Department modelling of collective defined contribution schemes, DWP London.

[11] We understand there will be continuing consultation and discussion on how the income efficiency of a CIPR may be tested. We will engage with that process. However, for reasons discussed elsewhere in this submission, we do not think that the CIPR framework as currently envisaged will generate sufficiently income-efficient outcomes for members.

The experience of MySuper has been that a focus on disclosure, transparency and data consistency has not been sufficient to improve the actual performance of many MySuper products for members. It follows that a similar approach to CIPRs cannot be expected to be successful.

Should the envisaged framework be implemented it is clearly in the interests of newly retired members to join a CIPR that has, among other things, an ABP with a record and reasonable expectation of delivering relatively high net returns to members. The CIPR framework appears to envisage that most of those new retirees who are already members of funds that offer a CIPR will remain in that fund. In the Discussion Paper the primary role of trustees is presented as 'easing' movement from the accumulation phase into an appropriate retirement product, which may be a CIPR.

In this context there will be few if any funds offering options other than remaining in a product they provide.[12] And given the low levels of engagement and understanding that many employees and retirees have in relation to superannuation and pensions, the signalling and framing they receive from their existing fund is likely to have a significant impact on what they decide to do. Inertia and risk-aversion is likely to lead many new retirees to stay with the fund they are already familiar with, even if it performs relatively poorly.

This can be overcome by energetic sales and advice activity, such as by highly motivated advisors targeting people nearing retirement with higher balances. But it is costly, and it is difficult to see how the benefits can justify the social costs of a sales-driven retirement income system for workers on upper middle and higher incomes. It is certainly the case that the sales-driven part of the accumulation system is very inefficient. We discuss these behavioural risks further in the next section.

The ABP component is particularly important because the performance of ABPs vary considerably. There is currently a dearth of data and analysis on the relative performance of ABPs and the sources of their differences in net returns. However, Table 1 presents some indicative figures.

Table 1 - Pension Fees, Crediting Rates & Retirement Benefits for Retail and Industry Funds

Fund types	Pension fees (bps)1	Pension Fund Crediting Rates2					Share of RSE assets in retirement phase (%)3, 4
		1yr	3yr	5yr	7yr	10yr	
Retail	171	10.58	7.29	9.29	7.43	4.2	70.4
Industry	93	13.12	8.67	10.62	8.93	5.96	17.1

Source: (1) Figures are for 2013, from Rice Warner (2014) Fees in Superannuation, submission to the Financial System Inquiry. (2) Crediting rates are calculated on a rolling year basis to March 2017, derived from SuperRatings Pension Fund Crediting Rate Survey (SRP50 Balanced). (3) Figures are percentage of total members' benefits in tax-free phase held by APRA-regulated funds, derived from ISA analysis of APRA fund-level superannuation statistics (June 2016). (4) The percentage figures do not total 100 because corporate and public sector funds are excluded.

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[12] While many members are likely to be open to advice to join a CIPR with a better ABP performance, and better overall income delivery profile, most advice in Australia is provided by advisors who act on behalf of for-profit banking and insurance companies. Under current law, these advisors are not required to consider the full universe of relevant retirement products when offering advice. They make much of their income from recommending products provided by particular for-profit financial institutions. We will discuss the potential role and limits of financial advice in a CIPRs context in the next section.

The data in Table 1 indicate that, on average, retail funds charge more and underperform industry funds. This pattern of underperformance is broadly consistent with the differential between retail and industrial funds in the accumulation phase. Moreover, the most inefficient segment of the system already holds the largest proportion of member benefits in the retirement phase at 70.4 per cent – evidence, in part, of the ability of retail funds to sell retirees into poor quality retirement products despite their high cost and underperformance.

The source of the inefficiency of the retail sector derive from its for-profit business model in a context where most members are disengaged and are not equipped to make rational decisions. The resulting inefficiency permeates the accumulation phase, resulting in lower average balances at retirement and lower average returns on their pension products during retirement. Aspects of this inefficiency includes the following:

Retail funds pay significantly higher fees to related party service providers - There is evidence that trustees of retail funds have paid significantly higher fees to related service providers.[13] APRA statistics indicate that 85 per cent of service provider expense is paid to internal or associated service providers in the for-profit super sector – compared to only 17 per cent in industry super funds and 41 per cent across all APRA funds. This suggests a need for strong regulatory settings, such as a quality filter and restrictions on related party transactions that do not benefit members.

Differences in asset allocation - Funds in our industrial ecosystem consistently make higher allocations to unlisted asset classes, including unlisted property and infrastructure.[14] This is in part due to many members in for-profit funds being placed in liquid investment options via a retail platform on advice from financial advisers, who need to be able to chop-and-change investments to maintain the appearance that they add value to clients. As a result, the asset allocation of many retail funds is tilted toward listed bonds, domestic equity and international equity; even alternative asset classes like property and infrastructure are invested in via listed vehicles.[15]

Excessive fees for passively managed retail MySuper products - The advent of low cost MySuper products offered by retail providers has been largely achieved through a shift to passively managed equities.[16] While the jury remains out about the long term performance outcomes of these products, Rice Warner has highlighted concerns that profits are being made by some funds who are inflating investment fees for passive investments.[17]

Economies of scale - APRA research found that the performance of retail funds does not improve with fund size, observing that the structure of retail funds, in the sourcing and offering of their investment products, is less conducive to capturing the benefits of scale.[18]

Legacy products - A substantial proportion of assets in the retail side of the superannuation system are legacy products. Independent analysis has demonstrated that legacy products are more costly than current products.[19] There is no publicly available data on the returns delivered by these products. It is not clear why

[13] Liu, K. and Bruce R Arnold, 'Australian Superannuation Outsourcing – Fees, Related Parties and Concentrated Markets', *APRA Working Paper*, 12 July 2010, p 2; see also Ellis, K., Alan Tobin and Belinda Tracey, 'Investment Performance, Asset Allocation, and Expenses of Large Superannuation Funds', *APRA Working Paper*, October 2008

[14] Cummings and Ellis, 2011, APRA Working Paper, Risk and Return of Illiquid Investments, p 24

[15] Cummings, J.R. and Ellis, K. (2015), 'Risk and return of illiquid investments: A trade-off for superannuation funds offering transferable accounts', Economic Record, 91 (295), 463-76472

[16] SuperRatings, AIST, Fee and performance analysis, 2015 at p.12

[17] Rice Warner, Superannuation Fees, FSI, p 30

[18] Cummings 2012, p. 31

[19] Rice Warner, Superannuation Fees, 2014.

significant assets remain in legacy products, why some trustees are inactive on this issue, and why advisers should continue to receive commissions from clients in legacy products.

Accrued default amounts - Accrued default amounts are defined in the SIS Act as amounts that are held in non-MySuper products in default investment options where the member has not made an investment choice. They represent default amounts that pre-date the MySuper legislation. The SIS Act requires that RSE's move their accrued default amounts to their MySuper product by 1 July 2017. However, retail funds have been transferring these amounts at a much slower rate than those in the industrial system. For example, as at 30 September 2015 retail funds continued to hold 9.5 per cent of total assets in accrued default amounts, compared to 1.5 per cent for corporate funds, 0.4 per cent for public sector funds and 0.1 per cent for industry funds. APRA data shows that the vast majority of accrued default amounts held in corporate, industry and public sector funds were moved into a MySuper product by March 2014. Retail funds have taken much longer to transfer these funds.[20]

The inefficiencies outlined above indicate a long-standing pattern of behavior by the retail sector in which the interests of members are placed second to those of shareholders. Some are directly relevant to the income-efficiency of the retirement phase. Funds that choose to pay higher fees to service and product providers that form part of the same corporate family, and who choose to charge excessive fees for passively managed assets, are very likely to continue to underperform in a CIPR framework.

Indeed the opportunities for taking advantage of members are likely to increase in a retirement product choice environment because of (i) the added complexity of the products and tailoring options, (ii) the lower financial capabilities associated with older age, and (iii) the heightened motivation for providers to develop more sophisticated sales techniques because of the high balances available and the opportunity to lock members into long-term longevity products.

Such behaviors and outcomes are foreseeable because they are a logical consequence of the for-profit business model. We would encourage policymakers to consider the risks they pose to future retirement incomes and what can be done to eliminate them. We believe our alternative model of how superannuation should be organized to deliver whole-of-life retirement incomes deals effectively with these risks. This is discussed in section 5 of this submission.

[20] http://www.apra.gov.au/Super/Publications/Documents/1511-ADA-SF-1509.pdf p. 4-5

4. Problems of Choice and Member Protection

The key policy problem to be solved in transitioning from an accumulation-focused system to a retirement income system is how to connect members to the most efficient retirement income products to achieve the social policy objective of super.

The Discussion Paper proposes a retail distribution approach with a "point-of-sale" at, or near, retirement. In particular, those approaching retirement would be directly solicited by their fund to join a CIPR on a "soft-default" basis, and this CIPR or some other product must be affirmatively chosen (unless the member withdraws from the fund). In other words, a CIPR will be offered which has the status of being the preferred product suitable for most fund members, but retirees must actively choose to join a CIPR or decide to take another course of action – perhaps using the CIPR as an "anchor" to compare and select another non-CIPR product.

The "member experience" at a point-of-sale will be of a range of choices: the member can choose to join the CIPR as offered, join a CIPR tailored to them, use the CIPR as an anchor for choosing another product, join an ABP, or exit assets from the system.

A forced point-of-sale at retirement requires policy makers to be certain that the provider making the retail offering will do so in the best interests of members, and that the members in receipt of the offering can be relied upon to make a decision that is truly in their best interests and consistent with the social policy objective of the system.

The Paper acknowledges that for many members making a decision about how to make the most effective use of their assets at retirement will be complex, requiring as it does balancing competing objectives such as providing for uncertain longevity while retaining access to liquidity for non-routine living expenses. The Paper does not discuss the risk that providers will act disloyally to members.

Given this complexity and the risk of provider disloyalty, the Paper nonetheless suggests that the choices demanded by the CIPR framework are likely to be in the best interests of those who make them because of three assumptions:

- Trustees will help members navigate the complex decisions they are required to make by providing a good quality mass CIPR suitable for most members.
- Retirees will make rational choice decisions, partly with the assistance of financial advice.
- Effective disclosure will help members evaluate financial products.

These assumptions and beliefs were common in the 1990s, but have since been empirically rejected. The assumptions differ from how actual markets operate, and how actual providers and consumer behave.

4.1 Trustee behaviours

The previous section, "Problems of Inefficiency", highlighted the different business models that operate in superannuation and how this leads retail and industrial system funds to adopt very different approaches to their members. Retail funds view members mainly as sources of potential revenue-maximisation, while industrial system funds view themselves as existing in a relationship of trust with members who therefore

deserve a high level of fiduciary care. These different approaches lead to very different approaches to investment, fees, and the prices paid by trustees for the provision of external services.

The evidence is that the pattern of retail behaviour characteristic of the accumulation phase continues into the retirement phase. It is unclear how the proposed CIPR framework could be expected to change this. For-profit trustees will design CIPR products in ways that embed current and future fees and charges that are profitable to them and their corporate parents, and which drain value from retirement incomes received by members. As Table 1 indicated, this is a characteristic of what is already happening in an ABP context.

The assumption in the Discussion Paper appears to be that in a CIPR context retail and industrial system trustees can be expected to deal with newly retired members with similar levels of fiduciary regard to their best financial interests. There is no reason to assume this will be the case. In particular, the notion that members will simply be offered or nudged into a good quality CIPR ignores how retail funds are likely to use product design, marketing and framing to maximise revenues during the retirement choice process.

There are a set of foreseeable sales-driven gaming behaviours that for-profit funds are likely to engage in at the point of retirement in the proposed CIPRs framework that will disadvantage members:

- Relying on the inertia and low-information of members to nudge them into a poor quality CIPR, the relative long-term underperformance of which is unlikely to be understood by disengaged members, and components of which may be very costly or impossible to exit.

- Promoting the purchase of CIPRs with no-exit annuity components as a means of retaining members in a context where initial entry costs may be low, but with the intention that they will be increased over time.

- Promoting a high-liquidity/high-fee product that exploits members' concerns about their money being locked into lower-liquidity/lower-fee product.

- Encouraging the tailoring of standard CIPRs for individual members as a means of charging and embedding higher fees and costs than those publically used for public dashboard and comparison purposes.

- Framing the mass CIPR as a minimum-quality retirement product on the basis of which members are up-sold into more complex and expensive non-CIPR products.

Aspects of these marketing and product-design strategies are already used by for-profit funds in the context of accumulation and retirement. Retail funds have developed an "option-proliferation" strategy that they claim is about empowering members by offering them multiple investment option choices, so enabling them to better express and meet their individual financial needs.

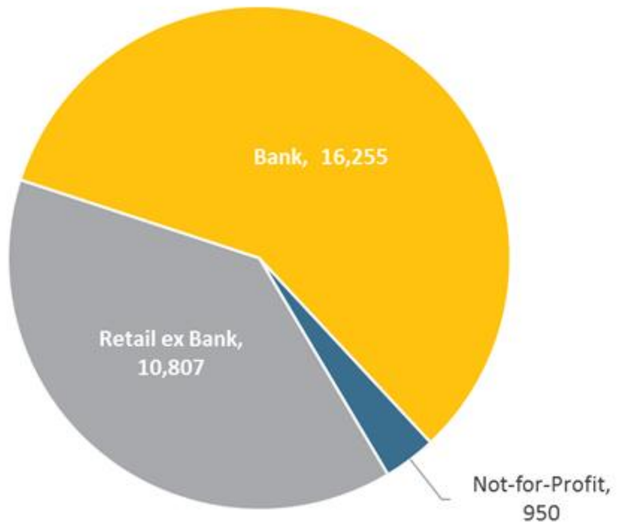
According to APRA data, in the year 2015/16 APRA regulated superannuation funds collectively offered 28,012 investment options. Closer inspection shows that the overwhelming majority of these options were offered by retail funds (bank and non-bank funds combined): 27,062 out of 28,012, or 97 per cent. Industrial system funds offered 950 options. This distribution is illustrated in Figure 1.

However, despite claims that option proliferation is about benefiting members, there is no correlation between the extent of option choice and performance. In fact the reverse is true: there is a clear correlation between poor performance and a large number of investment options. Funds that offer a lower average number of options perform better than those that offer many more:

- Funds in the top quartile of performance, with an average 10 year performance of 5.7 per cent, offer an average of 12 options.

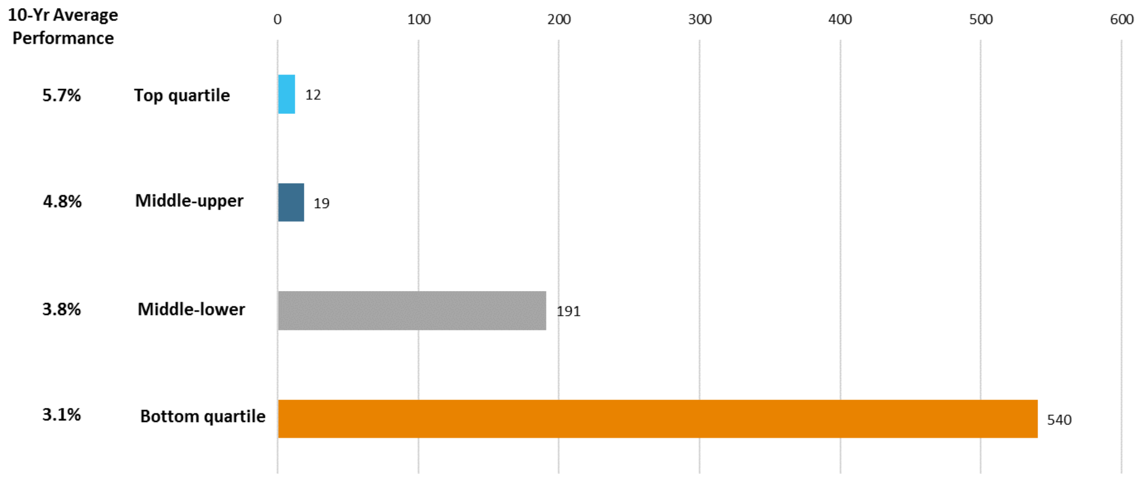
- Funds in the bottom quartile of performance, with an average 10 year performance of 3.1 per cent, offer an average of 540 options.

Figure 1 – Number of investment options by sector



Source: ISA analysis using APRA Annual Fund-level Superannuation Statistics 2016
Note: Only funds with 10-yr average returns are included in this analysis

Figure 2 – Average number of investment options per fund in each performance quartile & 10 year average returns



Source: ISA analysis using Annual Fund-level Superannuation Statistics 2016
Note: Only funds with 10-yr average returns are included in this analysis

The significance of this data is two-fold.

Firstly, option proliferation in superannuation is not about member benefit. In common with similar forms of option proliferation in the market for private health insurance,[21] it is likely driven by a desire to complicate the choice environment (a 'confusion marketing' strategy) and to derive fees from members who have been convinced that switching to another set of options is in their interests.

Secondly, it is foreseeable that retail funds will wish to replicate this complexity and revenue-generation in a retirement phase context. Even if a fund were to be limited to offering one CIPR, they will be able to offer multiple-tailoring options within that one product. Further, it is very likely that a CIPR will exist in a context of multiple retirement income products offered by each retail fund, with resulting proliferation marketed as being in members' best interests. The Discussion Paper argues that members can use a CIPR to anchor a rational decision. But confronted with perhaps dozens or hundreds of product design options, both within and outside the CIPR framework, we doubt anchoring will work like this in practice.

Such sales-driven strategies for retaining and charging low-information and vulnerable customers are common across the retail financial industry in Australia and abroad.[22] They are foreseeable risks in the context of transitioning superannuation into a retirement income system. The approach set out in the Discussion Paper does not acknowledge them.

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[21] See, for example, the views expressed by the ACCC in their 2016 report 'Communicating changes to private health insurance benefits.'

[22] A critical overview of marketing strategies commonly utilised by retail financial services is provided by Newman, K. (2001) 'The sorcerer's apprentice? Alchemy, seduction and confusion in modern marketing', International Journal of Advertising, Vol. 20, No. 4. See also the independent review of banking services commissioned by the UK government in 2000, which observed: 'Confusion marketing is a deliberate strategy by banks and financial institutions which has yielded 'abnormal returns' on UK personal banking markets.' Cruikshank, D. (2000) Review of Banking Services in the UK, Final Report, HMSO London.

4.2 Financial Advice, Member Behaviour & System Efficiency

The Paper states that the proposed CIPR framework is not intended to replace the need for financial advice. Given the range of complex options available to members in a CIPR context, access to good quality financial advice for those who want it will be important in a sales and marketing environment where for-profit funds are competing to retain members and attract new ones in order to meet internal sales and revenue targets.

However, the Discussion Paper does not discuss the high risk that many members will be provided with advice that is not in their best interests. They will therefore be at risk of making a decision that could significantly disadvantage them for the rest of their lives.

The view that financial advice in a general sense can be relied upon to help members navigate the complexity of the retirement income product decision does not take account of the business models at work in the advice industry and the risks they pose to those seeking assistance.

Much of the advice industry is characterised by the following features:

- Advice provision 'is dominated by the large Australian banks, AMP and their dealer groups' and industry concentration has increased in recent years.[23]

- Advice relating to superannuation and retirement is the largest area of business within the industry.[24]

- Most advice networks and dealer groups act as dedicated distribution vehicles for product manufacturers, such as the main banks and insurance companies. Priorities are determined by what has been described as 'an overarching sales culture' in which product development and advice functions often form part of the same vertically integrated corporate structures.[25] In 2014, for example, 77 per cent of superannuation products obtained via a financial planner were from the planner's parent organisation.[26]

- Across much of the retail product distribution/advice industry, the remuneration of advisors remains closely related to how successful they are at selling particular retail products.

Despite introducing a 'best interests' duty in the context of personal advice, the Future of Financial Advice reforms contained significant exemptions that continue to allow financial advisers to continue to be paid commissions and other forms of conflicted remuneration. These include:[27]

- A blanket exemption for benefits paid under grandfathering arrangements.[28] This incentivises advisers receiving trail commissions to recommend that members stay in a retail superannuation

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[23] IBIS World Industry Report: Financial Planning and Investment Advice in Australia, January 2017, p. 20.

[24] Ibid.

[25] North, G. (2015) 'The future of financial advice reforms: Will they achieve their long term objectives?', Competition and Consumer Law Journal, Vol. 22, p. 210.

[26] Roy Morgan (2015) Super and Wealth in Australia.

[27] For further analysis of the exemptions to the 'best interests' duty for personal financial advice, please see the Australian Institute of Superannuation Trustees submission to the Senate Inquiry into consumer banking, insurance and the financial services sector, 7 March 2017.

[28] Section 1528(1) *Corporations Act 2001* (Cth) and regulation 7.7A.16 *Corporations Regulations 2001* (Cth).

product, even if it would be in the best interests of the member to switch to a better performing or a less expensive contemporary product.[29]

- An exemption for advisors to receive advice-related benefits.[30] This allows a client to consent to an adviser receiving benefits from the dealer group for advice.[31]
- Volume-based benefits are not banned but instead merely presumed to be conflicted remuneration.[32] This presumption can be rebutted if particular circumstances are satisfied.[33]
- An exemption for benefits with an educational or training purpose.[34]
- An exemption for commissions on insurance.
- An exemption for benefits for information technology software and support.[35]

In this policy and sales-driven context the risk that members will be sold inappropriate and relatively poor performing CIPR products will be significant.

The insistence on choice in the context of a compulsory market for complex financial products not only risks exposing members to conflicted financial advice, it does not acknowledge the behavioural biases and cognitive limitations that research has shown can lead to poor choices and sub-optimal outcomes for many members.

The Discussion Paper acknowledges behavioural biases in the context of precautionary motives and liquidity preferences, arguing that these can be overcome by means of a soft default into some form of longevity pool. However, as noted above, by insisting on a retail point-of-sale with a soft default the CIPR framework actually presents members with a range of potentially complex choices. Therefore, policy in this context must take account of the full range of biases and limitations that are likely to be relevant to any cohort of members who retire in a CIPR context.

Relevant biases and limitations include the following:

Status quo bias. This describes when people prefer an existing set of conditions rather than risk losses by taking action to change those conditions.[36] This is often evident when people are confronted with complex decisions that they do not fully understand. The Discussion Paper discusses this bias in the context of a reluctance to join a longevity pool. But the bias is also evident in the fact that many members of low-performing superannuation funds do not leave to join a better performing fund. As discussed earlier, it also means that members of a poor performing accumulation fund are likely to remain with the fund at retirement because the perceived risks and costs of moving are judged to be too great.

Status quo bias, and resulting inertia, helps to explain why bank-owned public offer superannuation funds are able to retain millions of accounts, despite the fact that nearly 70 per cent of those accounts persistently reside in the bottom quartile of returns. This is illustrated, and compared with industry fund account performance, in Table 2. This data suggests that members do not respond to poor performance by

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[29] Australian Institute of Superannuation Trustees, Submission to the Senate Inquiry into consumer protection in the banking, insurance and financial services sector,' 7 March 2017, 42.

[30] Section 963B(1)(d) and 963C(e) *Corporations Act 2001*.

[31] ASIC Regulatory Guide 246 *Conflicted Remuneration*, para 246.66 and Example 1.

[32] Section 963L *Corporations Act 2001*.

[33] ASIC, Regulatory Guide 246, *Conflicted Remuneration*, Section C.

[34] Section 963C(c) *Corporations Act 2001* and regulations 7.7A.14, .7A.15 and 7.8.11A *Corporations Regulations 2001*.

[35] Section 963C(d) *Corporations Act 2001* and regulation 7.8.11A *Corporations Regulations 2001*.

[36] Melissa Knoll, 'The Role of Behavioral Economics and Behavioral Decision Making in American's Retirement Savings Decisions,' [2010] 70(4) *Social Security Bulletin*, 7; William Samuelson and Richard Zeckhauser, 'Status quo bias in decision making,' 1988 1(1) *Journal of Risk and Uncertainty* 7.

moving to better performing funds. If they did, the percentage of bank-owned accounts in the third and bottom quartiles would be much lower in 2016 than in 2015. Similar patterns of bias and inertia are very likely to pervade the retirement income phase because of the insistence on choice and the absence of a public-interest mechanism to actively filter out relatively poor quality products.

Table 2 - Distribution of industry fund and bank-owned accounts by performance quartiles in 2015 and 2016

	2015		2016	
	Industry fund accounts (%)	Bank-owned accounts (%)	Industry fund accounts (%)	Bank-owned accounts (%)
Top quartile	98.6	0.0	98.6	0.0
Second quartile	59.8	4.5	59.2	4.4
Third quartile	17.7	26.9	17.8	26.4
Bottom quartile	6.2	69.8	6.0	69.4

Source: ISA analysis of APRA Annual Fund-level Superannuation Statistics. Note: Quartile ranking based on funds' 10-year annualised returns to June 2016. Analysis based on member accounts belonging to public offer funds only. Proportions of industry and bank-owned accounts are relative to total number of public offer accounts within each quartile.

Ambiguity aversion. This can be a contributing factor to status quo bias. It describes when people prefer options for which the risks are known over options for which the risks are unclear, unknown or unspecified.[37] In the context of superannuation, members may feel that they have limited knowledge about superannuation matters compared to other topics and may therefore lack self-confidence as a result. In the CIPRs context, members may feel intimidated by the complexity of the potential choices available to them and avoid making a decision beyond accepting the option offered or promoted by their fund, which may or may not be a CIPR.

Decline in cognition with age. This concerns the well documented tendency for people to have decreasing capacity to manage their financial affairs as they get older, a consequence of which is that they become increasingly susceptible to miss-selling, scams and buying poor quality products. This is one reason why some financial firms focus their sales and marketing efforts on older cohorts of members and potential customers.[38]

Cognitive constraints. Most people, including the minority of people who are financially literate, have difficulty understanding probability, and make irrational decisions about risk.[39] Similarly, while most people substantially underestimate average life expectancy, even those with high financial literacy struggle to understand mortality risk and survival probability.

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[37] Knoll, above n1, 4; Colin Camerer and Martin Weber, 'Recent developments in modeling preferences: Uncertainty and ambiguity' 1992 5(4) *Journal of Risk and Uncertainty* 325-370.

[38] Lauren Willis, 'Against Financial-Literacy Education,' (2008) 94 *Iowa Law Review* 197, 205; Douglas Hershey et al, 'Challenges of Training Pre-Retirees to Make Sound Financial Planning Decisions,' 1998, 24 *Educational Gerontology* 447, 467. Finke et al. (2017), Old Age and the Decline in Financial Literacy, Management Science, 63(1), 2017, pp. 213-230; Gamble et al. (2015), How Does Aging Affect Financial Decision Making?, Center for Retirement Research at Boston College, p. 4.

[39] D Kahneman Maps for Bounded Rationality: Psychology for Behavioural Economics The American Economic Review (2003) 93 1449.

Framing effects. People are easily influenced by decision framing – they make a choice based on how the options presented to them relate to one another, how they are explained and what information is provided at the same time. Research into the impact of investment menu design on choice of investment options has found that menu design is a more powerful influence on decision-making than the risk-return characteristics of the options themselves.[40]

Limited repeat learning opportunities. In many markets consumers have the opportunity to learn from poor choices, and so adjust their future choices accordingly. In some markets there may be only one time-specific opportunity to make a choice, meaning that the costs and risks of a poor choice to consumers increase significantly. The Discussion Paper acknowledges this issue in the context of retirement income decisions. But the Paper suggests this is a problem because the default system allegedly encourages passivity and low-engagement.

This emphasis on the default system neglects the deeper and more complex sources of low engagement and literacy: the very few opportunities that most people have to learn and make routine use of complex financial concepts during their lives; and, in particular, the deliberate use of complexity and marketing noise by product providers to make rational consumer choice less likely - rather than more.[41]

Underlying much of the thinking in the Discussion Paper appears to be a view that member choice, even when forced on those who lack the capacity to navigate a highly complex and profit-hungry financial universe, is to be encouraged. However, in superannuation the evidence is that choice is negatively associated with financial outcomes.[42]

In addition to overcoming significant behavioural biases and cognitive limits, making rational choices in a complex superannuation and retirement income context with multiple products and options would require members to have to have a minimum basic knowledge of the following topics:

- Finance and investment, including key concepts such as the risk-return relationship, the equity risk premium and the limits of diversification;
- Financial products – how key investment variables are reflected across various product offerings;
- The variety of ways financial products can be priced (and the comparative impact of different pricing structures on net returns over time); and
- The ways various financial products interact with the tax-transfer system.[43]

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[40] Mitchell and Utkus at 15.

[41] Reflecting on the persistent failure of sustained attempts to empower US consumers by increasing financial literacy, one academic researcher has concluded: 'The financial-literacy education policy model locates the problem of and the solution to poor financial outcomes in the consumer, but these can be conceptualised just as easily as part of the choice architecture of personal-finance decisions. Because changing the consumer does not look promising, consumer financial woes are more tractably understood as the result of a government that fails to regulate, an industry that hawks inappropriate products, and a deluge of complex products that change quickly': Willis, L. E. (2008) 'Against Financial-Literacy Education', *94 Iowa Law Review*, Vol. 197, p. 283.

[42] See, eg, Gan, Su et al, 'Individual investor portfolio performance in retirement savings accounts,' (2014) *Australian Journal of Management* (analyzing 10 years of data for 15,000 members and finding that "switching activity is invariably associated with lower risk-adjusted returns (alphas) and this is also evident across the various analyses reported.")

[43] Industry Super Network, 'Supernomics: Addressing failures of competition in the superannuation market,' March 2010, 10.

Financial literacy and engagement strategies can create a dangerous mix of rising member confidence in decision making capability, but no material improvement in actual decision-making capability (or even decreasing capability).[44]

There is a further problem with how the Discussion Paper envisages the role to be played by financial advice in the envisaged retirement product context.

As noted above, the Paper states that the proposed framework is not intended to replace the need for advice. However, the Paper does envisage members accepting the 'CIPR offer' (standard or tailored), or using the offer to anchor another choice, without necessarily requiring personal financial advice. If the CIPR framework is implemented, advice will almost certainly be demanded by members because of the extraordinary level of complexity that has become embedded in superannuation, which would be amplified by the CIPR framework. The question is simply who provides the advice.

The precise nature of the tax and pension means testing environment within which CIPRs may operate is in the process of being decided.

Nonetheless, it is clear that a wide range of product design variation (within and outside the CIPR framework) will come to characterise the retirement product landscape, combined with the complexity of the tax and social security environment, will mean that most retirees will not be in a position to judge which product will combine with any other assessable income and assets to optimise their total retirement income. Put another way, retirees will be unable to predict what their retirement income will be unless they consult a professional.

The universe of multiple and variously designed retirement income products that the Paper appears to believe will benefit retirees, will very likely generate a huge increase in the need for personal financial advice. At a macroeconomic level this will re-direct scarce resources of capital and labour away from potentially more productive and welfare-enhancing activities, into an expanding financial advice industry. Even if it was worthwhile to create more demand for financial advice, and allocate more resources to providing it, such advice will be heavily mediated by the conflicted nature of the sales-driven business models within which many advisors will operate.

In sum, complex product proliferation in the context of complex tax and social security policy settings will re-direct value toward the advice industry, away from members. The system-wide costs of this further inefficiency is likely to be significant, further undermining the potential wellbeing of retirees.

4.3 Disclosure

ISA supports disclosure for regulatory purposes and to assist those members and industry professionals who wish to make use of the information provided.

However, there is no evidence that disclosure, even when presented in a manner intended to engage members, is sufficient to generate rational choices.[45] Disclosed information is only useful in a context

[44] Willis (2008).

[45] Research into the effect of simplified disclosure in the US mutual fund market, for example, showed that simplified product descriptions had no discernible impact on investor decision making, even for subjects with above-average levels of financial literacy. See Beshears, J., Choi, J.J., Laibson, D., and Madrian, B.C., (2009), 'How does simplified disclosure affect individuals' mutual fund choices?', Working Papers, Paper 14859, National Bureau of Economic Research.

where people have the capacity and motivation to make effective use of it. For reasons already discussed, the act of disclosing information to members who are not persistently engaged, dispassionate financial experts, in a context where conflicted financial advice is commonplace will not secure such use.

The MySuper dashboard is sometimes cited as an example of how the structure and target performance of other products could be made more comprehensible to members. The Discussion Paper mentions dashboards as a possible way to facilitate the comparability of CIPR products. While we support the production of dashboards to assist those members, regulators, and industry professionals who find them useful, there is no evidence that MySuper dashboards have driven significant numbers of members to join better quality MySuper products.

Indeed, there is anecdotal evidence from within the industry that the most frequent users of online MySuper dashboards are those who work in superannuation and who use them for generating market intelligence on what rival funds are doing.

Those members who do attempt to make use of these dashboards are likely to find many of them confusing and difficult to compare, in part because some retail funds make use of lifecycle investment strategies that complicate the comparison process with non-life cycle products. Reflecting on the MySuper landscape Rice Warner has offered the following view:

> 'The diversity of Balanced Funds and the increased use of lifecycle funds…have made it harder to compare funds than ever before. That is, many superannuation funds are seeking ways to differentiate their product offering through the structure of their default investment offering. While the intent is to design a default that aligns to the value proposition, many members would be hard pressed to know which to choose.'[46]

4.4 Real freedom and choice

The Discussion Paper promotes a concept of freedom and choice that is quite narrow: the freedom to "choose financial products" offered in a mandated system.

There are two issues here that deserve explicit recognition and discussion:

- First, increasing individual freedom to choose a financial product actually decreases individual consumption freedom. This is because, as has been clearly demonstrated, retailisation shifts value from members of the superannuation system to providers, leaving members with less income or wealth. As a result, the choices that members can make about how they spend their time in retirement and what they consume are reduced. Their freedom to realise their individual preferences are constrained because they can afford fewer goods and services.
- Second, increasing individual choice sacrifices social welfare.

The Paper assumes the value of nudging over mandating because promoting individual freedom of choice (of financial products) is assumed to be a first-order priority. However, this overlooks the significant tensions that can exist between choice and social welfare, effectively assuming that the exercise of choice by individuals will necessarily aggregate to improve collective social outcomes.

While this can be true of some citizen and consumer behaviours, the problematic nature of this reasoning in the context of superannuation was recognised in 1992 when contributions were mandated rather than merely encouraged. It was judged, correctly, that the costs to long-term social welfare of delegating

[46] Australian Institute of Superannuation Trustees and Rice Warner, 'Navigating the New MySuper Landscape,' 2014, p. 9.

retirement saving decisions to individuals would be too great to justify hoping that behaviour would change.

It was with our superannuation system in mind that led a recent Melbourne Institute paper to conclude that "Nudges typically sacrifice social welfare in favour of individual choice."[47]

In a CIPR context the Discussion Paper does not acknowledge and discuss the likely costs to social welfare of prioritising choice. Instead, the Paper appears to assume that individual choices will aggregate to improve social welfare, despite the risks and costs documented in this submission and for which evidence has been widely available for some time.[48]

The trade-off between social welfare and individual choice (about superannuation products) is not a closed question in the context of superannuation. Very few members make active choices about superannuation products, and even fewer show sustained interest in product choices. It is likely that there would be even less activity by members if there was not widespread selling and engagement efforts.

The behaviour of individuals reveals preferences, and it is clear that relatively few people attach significant value to the opportunity to make superannuation product choices, and even less would do so naturally (i.e., in the absence of sales). By contrast, the for-profit financial services industry strongly values deregulated product choice, because such choice is intrinsically also the opportunity for the provider to sell products that would not pass a regulatory hurdle.

The Discussion Paper's concern with choice as a first-order priority also leads to a limited understanding of what 'freedom' should mean in the context of an efficient retirement income system.

In the Paper, freedom is the freedom to choose a financial product or, in reality, the freedom to be sold a poor quality financial product regardless of the broader and longer-term social consequences.

A public interest definition of freedom involves something qualitatively different and better than this.

In a context where power in the market for superannuation (in the form of knowledge, resources and motivation) resides overwhelmingly with providers, the priority for policymakers should be to enable individuals to express their particular preferences on the basis of the highest and most stable retirement incomes that policy-settings can provide. In this context, 'freedom' that has real meaning to retirees is the greater freedom to act because they have the resources they need to do so.

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[47] Finighan, R. (2015) Beyond Nudge: The Potential of Behavioral Policy, Policy Brief No. 4/15, Melbourne Institute, p. 2.

[48] See, for example, submissions by ISA (among others) to the Cooper Review in 2009, the Productivity Commission review of default funds in modern awards in 2012, the Financial System Inquiry in 2014, and the current Productivity Commission inquiry into the efficiency of the superannuation system.

5. A Better Approach

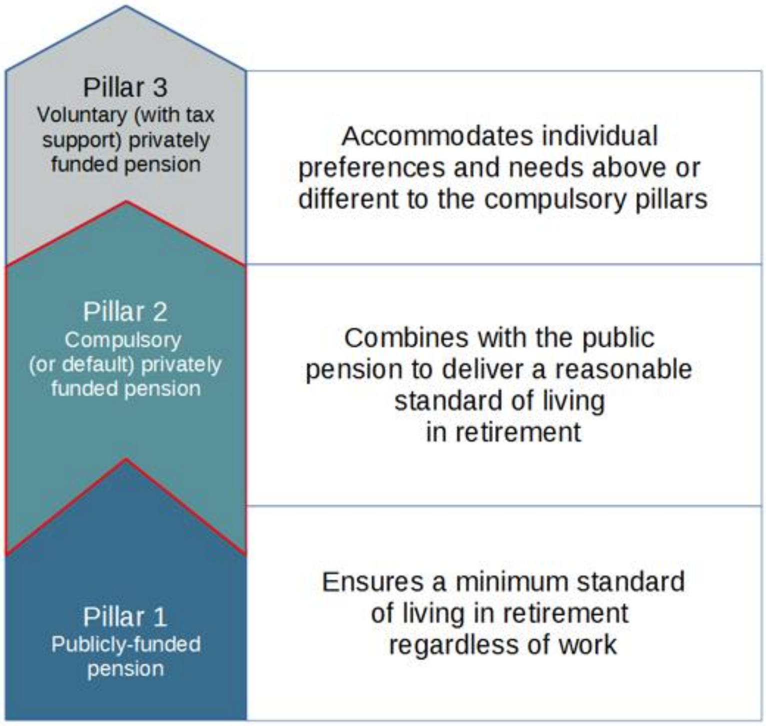
For the reasons discussed above, we do not believe that the CIPRs framework will deliver the efficiencies and member protections that a world class retirement income system should be aiming to achieve. In practice it risks embedding poor performance and exposing members to the risk of joining poor quality products.

However, securing the efficiencies and protections we need does not require that we rebuild our superannuation system from scratch. Important elements of a better retirement income system already exist in Australia. And there is scope to apply approaches from the best pension-focused systems in the world to deliver better outcomes and protections than we currently do.

5.1 The Three Pillars

The World Bank notes that the national retirement income systems of most developed countries can be thought of as comprising 3 pillars (see Figure 3 below).[49]

Figure 3 – The World Bank three pillars model



Pillar 1 comprises some form and level of publically funded pension payment to all those in a country who meet certain citizenship, contribution and/or residence criteria. It is intended to counter the risks of individual myopia and low earnings by providing a minimum stream of income that guards against extreme poverty in old age.

[49] World Bank (2008) The World Bank Pension Conceptual Framework, Washington.

Pillar 2 comprises some form of mandatory system in which employees and/or employers are required to make contributions to privately operated funds who invest those contributions for the purposes of generating an income in retirement that complements that available in Pillar 1. In most countries, this is an "occupational pension", with strong regulation about how members join products based on the workplace, and the form of the benefit is a stable retirement income for life. Australia is different, in that there is strong regulation to compel savings, but gradual deregulation regarding how members join products, and relatively little regulation about the form of the benefit.

Pillar 3 comprises additional tax-advantaged voluntary contributions that accommodate the individual preferences of those who can afford to make such contributions and who want to accumulate additional wealth for retirement in ways that may not be possible under Pillars 1 and 2.

Australia occupies a problematic position in this three pillar framework.

Over time, the boundary between Pillars 2 and 3 has become blurred. Compulsory superannuation in Pillar 2, which is mandated for the social policy purpose of combining with the Age Pension to deliver higher living standards in retirement for all, has increasingly become a target for the selling of tailored choice products that should be in addition to Pillar 2 – not a dilution of it. This would not be a concern if such choice products resulted in better outcomes for those who joined them. However, as shown earlier in this submission, choice products typically underperform industrial system defaults.

In short, our Pillar 2 has become increasingly retailised and increasingly a source for economic rent, and therefore increasingly inefficient, when it should be acting solely to maximise the incomes of all those required by law to contribute to it. Reversing course is possible, and only will require policymaking based on evidence.

The problems of retailisation and inefficiency are not endemic to all Pillar 2 pension systems. These problems exist in Australia partly because for the past 20 years there has been a widespread belief in policy circles that maximising individual choice – which, because of the behavioural issues outlined earlier, is equivalent to maximising opportunities for the finance sector to sell inefficient products – is the best way to increase benefits to members. We now know that this belief is false.

Not all countries have adopted this belief. The best Pillar 2 retirement income systems in the world take a different approach. It is worth looking at what they do.

5.2 The best Pillar 2 systems

Netherlands and Denmark are widely regarded as having the best Pillar 2 systems in the world.[50] They have held this position year after year, and continue to do so.[51]

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[50] See, for example, the Retirement Income Adequacy Indicator published by Allianz in 2015. They note: "As an overall picture the [Retirement Income Adequacy] indicator ranks pension systems with mature funded pillars in developed countries at the top: The Netherlands are clearly leading the list followed by Denmark and Norway."

See also, Melbourne-Mercer Global Pensions Index (describing each of Netherlands and Denmark as a "first class and robust retirement income system that delivers good benefits, is sustainable and has a high level of integrity." (Melbourne-Mercer Global Pensions Index, p. 7)

[51] See, Melbourne-Mercer Global Pension Index 2016 and preceding years.

The reasons why the Netherlands and Denmark consistently rank so highly can be found in the distinctive nature of the model these countries have adopted for their Pillar 2 systems. Pillar 2 in these countries follows the 'industrial model', which comprises the following key features:[52]

- Almost all pension funds that operate in the Pillar 2 space are private, not-for-profit organisations governed by boards that comprise representatives of employers and employees.

- Pension product distribution is via the workplace, with most employees allocated to default products that are decided by industry-wide or enterprise collective agreements between unions and employers.

- The default that most employees are allocated to is a whole-of-life product that automatically delivers a lifetime indexed pension.

Because funds are operated in the context of their industrial systems, in which a culture of service to others pervades how members are treated, there is no profit-drain from the industrial model and no shareholder-generated incentives to push high-margin products to members for the purposes of maximising revenues. Furthermore, the workplace distribution of products eliminates the need for high marketing spends and expensive forms of competitive promotion.

The industrial model that operates in Denmark and the Netherlands, and a number of other countries such as Iceland, Sweden and Finland, is clear evidence that Pillar 2 systems can be operated in the interests of members without requiring a profit-motive, inter-fund competition and an aggressive sales-based distribution system – all of which extract value that should be going to members.

5.3 Making it happen in Australia: a better way to transition to a retirement income system

In an Australian context, important elements of the industrial model already exist. We have a large and successful industrial system of funds that routinely outperforms the retail sector. That outperformance flows from a culture of service to others that cannot exist in a retail environment because for-profit funds have a primary commercial duty to their corporate parents and the shareholders that invest in them.

The culture that places member interests first is reinforced by the role our industrial relations system plays in reviewing the quality of workplace default products and distributing them in a low-cost manner that recognises the distinctive needs of employees in particular industries. In common with those countries that operate the industrial model we have a set of collective industrial instruments (modern awards and enterprise bargaining agreements), overseen by the Fair Work Commission, that help to ensure many employees are allocated to good quality products without being forced to choose in a context where they have low-information and are vulnerable to marketing risk.

The benefits to members of being allocated to default funds via our system of modern awards is illustrated in Figure 4 (below). Funds named in awards as eligible defaults have outperformed other parts of the system. This is not accidental. In the context of the Fair Work Commission, the deliberations of which are removed from financial industry lobbying, marketing noise and sales pressures, the representatives of employers and employees are well-placed to decide which funds are in the best interests of employees.

[52] For further details on the structure of the Dutch and Danish Pillar 2 systems see Better Finance (2016) Pension Savings: The Real Return, Brussels.

And this is reflected in the outperformance of defaults that appear in awards compared to those product options outside the awards system.

However, despite the many strengths of the industrial superannuation system in Australia, there are some important differences between our retirement income system and those in Denmark and elsewhere.

Firstly, and despite evidence to the contrary, there remains a dogmatic insistence by some in policy circles (with the support of banks and retail funds) that promoting competition and sales to individuals is the most effective way to improve retirement incomes. For the range of efficiency and member protection issues already discussed in this submission, that is simply not the case. This view is not taken by governments and regulators in countries that organise their Pillar 2 systems on an industrial basis – for reasons that should be obvious.

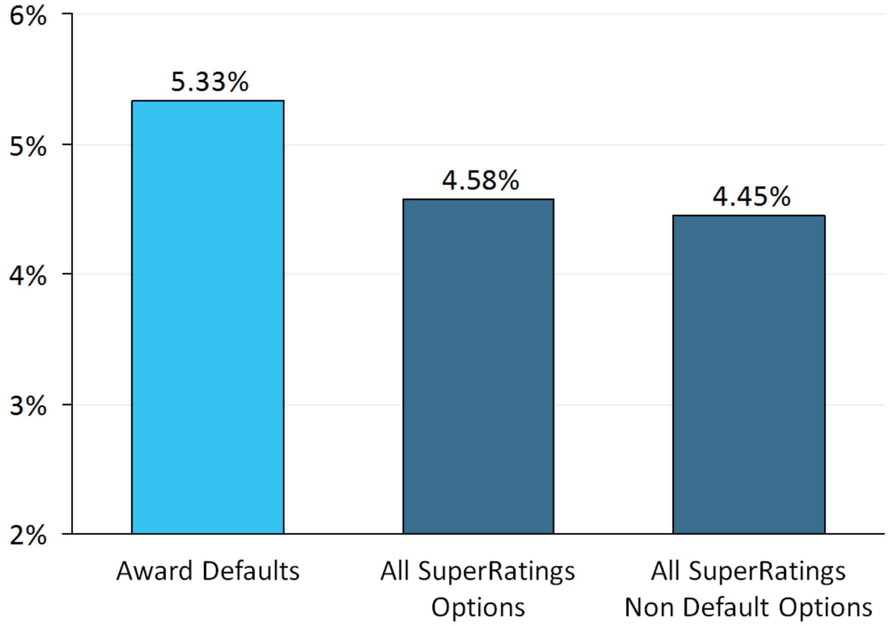
In the UK, where there remains a strong policy commitment to competition as the main solution to the abuses and poor outcomes for consumers that characterise retail financial services, Professor Karel Williams and his team at Manchester University have offered the following view:

> 'The great hope [held by policymakers] is that future abuses will ultimately be prevented not by all-seeing regulators, but by empowered rational acting customers…Within this generic competition frame, after endless failures, the standard policy response is always that competition could work if customers behaved with homo economicus motives and maintained vigilance over prices and charges. Such behaviour is unlikely [because] various surveys have shown that quite large numbers of people have a tenuous understanding of their own finances and are not well prepared for making good choices of financial products.'[53]

Secondly, despite the social policy role that our Pillar 2 system is intended to play, there are no substantive obstacles or hurdles to low-information members being sold out of the protections afforded by our industrial default system into retail choice products that, on average, routinely underperform. They underperform in the accumulation phase and the retirement phase. This has negative consequences for those individual members and for the broader retirement income system. The profit-cost to members of being sold into poor performing products will eventually be borne by those members (in the form of lower retirement incomes) and future governments (in the form of higher pension expenditures).

[53] Bowman, A. et al (2014), p. 106

Figure 4 – Performance of defaults named in awards compared to other options



Source: SuperRatings Smart Database, ISA analysis of SuperRatings option-level data for 46 funds listed in awards for which data are available. Note: Performance is the average for the 10 years to September 2016.

Thirdly, our system does not offer whole-of-life products that span employment and retirement without requiring a set of complex choices at the moment employees leave the labour force. Our current two-stage process – which the CIPR framework entrenches and further complicates – forces choice on those who are often unable to make good choices, and risks their being sold into an income-inefficient product that will risk lower retirement incomes.

In place of forcing complex choices on retirees, we should be seeking to replicate the experience of retirement plans in countries such as Canada, Denmark and Netherlands. There, many or most employees are members of industrially-distributed not-for-profit retirement plans that transition members from employment into retirement without insisting that they navigate a risk-intensive universe characterised by product proliferation. Instead, they can usually make a set of relatively simple choices about benefit design relating, for example, to commutation and reversionary pension payment. One way of delivering this 'member experience' is a CDC structure. Contrasting CDC with DC plans, Aon Hewitt noted that:

"CDC plans do not require specific member involvement in the key issues of investment choices and annuity purchase. As a pooled arrangement, a CDC plan trustee board sets the investment strategy and pays out benefits, including pensions to pensioners so that individual annuity purchase is avoided."[54]

Far from demanding to make good decision making on complex issues about longevity, liquidity and asset allocation, most members of these plans are content to trust their industrial system funds to transition them into a life-long income stream that will not involve a gaming of fees, margins and revenues to the advantage of shareholders.

[54] Aon Hewitt (2013) Collective defined contribution plans, p. 6.

In short, most members want to be able to trust their funds to provide a relatively predictable and stable retirement income. They do not value product choice in the manner assumed in the Discussion Paper.[55]

We recommend that Treasury examine the experience of what the best pension systems in the world do, and how the most successful and effective elements of the Australian superannuation system can be built upon in the best interests of employees and future retirees. The proposed CIPR framework does neither.

Our examination leads us to recommend that all funds and products that wish to receive employer contributions should meet the following criteria:

- They should be distributed via the workplace, with decisions about fund selection made by the industrial representatives of employers and employees under the jurisdiction of the Fair Work Commission. This recognises the importance of a quality filter and that workplace distribution in the context of collective industrial determination is the most efficient and effective means of connecting employees with good quality products that are relevant to their industry and workplace.

- They should operate in a manner consistent with the social policy purpose of superannuation, e.g. by precluding profits being taken for below average performance, or even by requiring funds to operate on a not-for-profit basis. This recognises that extracting profit from employees and retirees (in the form of high-fees, underperformance, cross-selling or up-selling) self-evidently contradicts how an income-efficient retirement system should operate.

- They should be whole-of-life products that span employment and retirement, and do not force product-related choice at the point employees leave the labour force. Within the whole-of-life products members would be able to make a series of simple decisions at retirement about their benefits to provide for matters such as commutation and a reversionary pension.

- Funds would focus on reporting probable retirement income outcomes to members of the products they are in, rather than periodic accumulated balances. This will help to overcome the artificial division between accumulation and retirement that characterises our present system, and help to focus the thinking of funds, members and policymakers on what retirees will receive in terms of eventual retirement benefit. It will also help to protect vulnerable new retirees from marketing pressures.

At present the benefits to many fund members of existing forms of annuity-based longevity insurance are far from clear. It should therefore be a matter for each trustee to decide how best to design their whole-of-life products in light of their particular member demographics and ongoing innovation in relation to how the full set of risks that retirees face can best be managed.

In the context of the above criteria, individual employees would be free to exit the protections afforded by the industrial model. However, because joining funds that underperform imposes individual and collective social costs, it is reasonable that funds should meet certain criteria if they wish to obtain members who have already been allocated to good quality products as a result of the provisions contained in modern awards and enterprise bargaining agreements.

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[55] For evidence on this in a Canadian context see: Healthcare of Ontario Pension Plan (2014) The Emerging Retirement Crisis, Research Paper, Part Two. Their survey of Ontarians found that what employees valued most in their pension arrangements was stability, security and adequacy. For similar conclusions in a UK context see: National Employment Savings Trust (2015) Improving consumer confidence in saving for retirement, London.

Such criteria could include:

- A better-off test: a requirement that providers do not provide advice or solicit a member acquisition unless the provider has reasonably determined that the product would leave a member better off from a financial point of view, and

- An earned-profits requirement: this would seek to better align the interests of fund members and providers. It would require a superannuation fund (or the average member of that fund) to achieve above-median net returns for a specified period before profits from the superannuation business of which the fund is a part is allowed to pay profits to shareholders. In this way, shareholder profits would have been "earned" by means of outperformance.

Drawing on the above discussion, the main points are:

- The key task is to connect the workplace superannuation contributions made by employees to the best funds offering products that deliver the sought-for form of benefit (i.e. a reasonably stable and predictable retirement income that lasts for life, which converts contributions over time into such income as efficiently as possible).

- Because the large majority of employees are not engaged with super and operate with low levels of information about what is in their best interests, there is a default safety net determined and policed by the Fair Work Commission and the enterprise bargaining process.

- Representatives of employers and employees decide which funds are best for the employees in their industry and workplace. This selection will focus on probable net retirement incomes, supplemented by additional considerations such fund performance to date, the availability of insurance appropriate to particular occupations, and the willingness of funds to undertake pro-active compliance work on behalf of members.

- Members allocated to the best funds are defaulted into whole-of-life products that focus on reporting probable future benefits, and which offer a seamless transition into retirement. The priority is on delivering the highest and most stable income possible, on the basis of which members will have a greater freedom to make individual consumption choices.

- The longevity of retirement incomes is underpinned by pooling. The specific structures will be subject to ongoing innovation, but it appears that an open Group Self Annuity or CDC would achieve mortality pooling and reduce value-leakage to third parties such as life offices. A CDC would enable sustained exposure to growth assets.

- When members retire, they can make a simple set of benefit design decisions on matters such as commutation and reversionary benefits. There is no forced-choice, no self-interested point-of-sale marketing pressures, and no uncertainty about how each retirement income stream will interact with tax and social security regulations. This approach to benefit design is consistent with the social policy purpose of superannuation because (i) in a mandated system most members lack the capacity to make complex product and pension-related decisions, (ii) it increases income-efficiency, and so maximises collective social welfare, by minimising the costs and risks associated with

individual choice, and (iii) it is consistent with what we know most members want in retirement – the provision of a good, stable and predictable income.[56]

[56] Research by the Department of Work and Pensions (DWP) in the UK reached similar conclusions. In a context where most retirees self-reported low knowledge and understanding of retirement income issues “people seek clarity, simplicity and certainty” p. 107 in DWP (2012) Attitudes to Pensions, Research Report 813, London.

APPENDIX A: ANSWERS TO SELECTED DISCUSSION QUESTIONS

In this submission we have argued that policymakers now have an important opportunity to design a world -class retirement income system that builds on the evidence of what works well in Australia and in the best pension systems in the world – those in Denmark and the Netherlands.

Unfortunately, the Discussion Paper does not ground its proposals in evidence and experience.

Despite ample evidence that promoting choice amid consumers who are not persistently engaged, dispassionate financial experts, and the revenue-maximising strategies of for-profit providers has not benefited most members or the broader superannuation system, the Paper insists that new retirees be forced to choose. Based on experience it is foreseeable that forced-choice in a CIPR context will disadvantage many members, and generate system and economy-wide costs in the form of increased demand for personal financial advice that will further undermine the income-efficiency of superannuation.

In addition, by further facilitating the use of life office annuities to manage longevity risk, the CIPR framework will embed expensive and income-inefficient products into our retirement income system. The main winners from this will be life office providers, and those funds that seek to utilise annuities to lock members into their customer bases for the duration of their retirement.

Therefore, ISA cannot support the CIPR model proposed by the Discussion Paper. It is this context that our responses to a selection of the Paper's Discussion Questions should be understood.

1. Are there any lessons from defined benefit schemes that can be applied to the CIPRs framework?

The evidence from where DB funds continue to operate in Australia and abroad provide a number of useful insights for policy makers:[57]

- Members prefer the form of benefit provided by a DB plan.
- Members feel more secure with a benefit that is not subject to short term market volatility.
- Members are content to be transitioned into a retirement income stream without being required to make a set of complex choices at the time they retire. Because DB schemes are operated on a not-for-profit basis, often with joint employer-employee trustee representation, most DB members are satisfied to trust their funds that they will be provided with an income that is not at risk of being diluted by the gaming of fees, margins and revenues to the advantage of shareholders.
- DB and DB-type schemes (such as CDCs) encourage a long-term and retirement income-focused mindset among trustees which involves matching future liabilities with assets. Compared with the two-stage DC/CIPRs model envisaged by the Discussion Paper, this mindset is more consistent with what the design and priorities of a proper retirement income system should be.

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[57] Research by the Healthcare of Ontario Pension Fund is relevant in this context. See footnote 55, page 34 of this submission.

These are among the reasons we recommend a whole-of-life retirement income product that employees join when at work, and which then transitions them into a retirement income stream unless they actively choose another provider who meets a better-off test or an earned-profits requirement.

A key lesson from DB schemes is that when members are in funds that are aligned to their interests, and not to those of shareholders, they do not need or demand the kind of complex product choices that the CIPR framework is proposing to impose.

2. How should income efficiency be defined?

Efficiency in this context is fairly straightforward: it is maximising the output desired by public policy per unit of input. The relevant inputs are member contributions over time, and government contributions (either direct or tax concessions). The sought-for output is reasonably stable and predictable retirement income that lasts for life. Accordingly, an efficient retirement income product is one which maximises the expected periodic retirement income that is stable and predictable for each dollar of contribution made by members and government (taking into account the age of the member who is the beneficiary of a contribution).

Achieving efficiency requires maximising long term net returns, and managing longevity risk. The challenge is that maximising long term net returns requires a higher allocation to growth assets, which are generally relatively volatile, meaning that retirement income based on such assets is risky, and therefore difficult to predict and unstable. By pooling short term investment risk across cohorts of retirees and working members, relatively stable and predictable retirement incomes can be achieved while maintaining a high allocation to growth assets. Managing longevity risk involves pooling the risk and allocating it fairly, a concept clearly understood by the Discussion Paper.

Aside from achieving these characteristics: maintaining high long term net returns and longevity risk pooling, a primary concern of policymakers should be to limit leakage from our superannuation system in the form of excessive fees, costs and profits that act to reduce the net income that retirees receive from the organisations that administer and invest their accumulated contributions.

An important source of this leakage is the for-profit business model of retail funds and the value they extract from members in the form of routine underperformance, upselling, cross-selling and the payment of excessive charges to related service providers. This leakage is likely to be embedded by the use of income inefficient life office annuities and the increasing need for personal financial advice to navigate a complex product universe and its relationship to tax and social security settings.

This leakage is why we have recommended a public-interest selection filter for whole-of-life retirement income products, based in our system of industrial awards and enterprise bargaining, which will periodically ensure only the best funds are entitled to receive workplace super contributions.

3. What elements/types of flexibility are most valued by individual in retirement, and does flexibility need to be provided for through a CIPR?

The likely widespread use of life office annuities to provide longevity insurance creates significant dilemmas for the CIPR framework. On the one hand, maximising income from an annuity will involve minimising flexibility for members. On the other, providing flexibility will come at a cost, further reducing the value of the annuity as a source of income.

For-profit CIPR providers, particularly those who share a corporate structure with a life office, are likely to favour inflexible annuities for reasons that are compatible with their business strategy: they can be marketed as providing the highest annuity-type income, and they lock-in members for the duration of the

contract. They will be able to capture members for life, potentially increasing fees and charges without running the risk of losing even the small minority of members who are sufficiently engaged to potentially act.

In addition, it is difficult to reconcile the Discussion Paper's vision of greater member choice driving better member outcomes with a product design that relies partly on inflexibility to help deliver higher retirement incomes.

4. Are there any risks or issues with trustees partnering with third parties to enable them to offer certain underlying component products of a CIPR?

As indicated above, and discussed in the main body of this submission, life office annuities do not appear to be compatible with an income-efficient retirement income system.

Superannuation funds that share corporate structures with parties that provide services to the funds typically pay higher fees for those services than industrial system funds who typically contract services on an arms-length basis. This business practice is an important source of the revenues that retail funds are expected to generate for their corporate parent. As such, this practice is very likely to continue, although potentially adjusted to skew higher service fees, and higher related charges to members, to later in the duration of the annuity contract.

All business relationships between superannuation funds and third party annuity providers will drain value from members because of the for-profit nature of such providers and the nature of the capital base that supports annuity supply. This is one reason why approaches such as a Group Self Annuity and Collective Defined Contribution scheme, offered directly by a fund or collective of funds, are more consistent with securing income-efficient sources of retirement income.

5. Would a safe harbour for their best interest obligations remove a key impediment to trustees designing and offering CIPRs?

In general, making a safe harbour available in the context of product offerings to members is inappropriate because trustees should only offer products that they can demonstrate to members and regulators are in the best long-term financial interests of those who join them. There should be no process-based defence available to trustees who cannot show this to be the case.

The CIPR framework does not contemplate, and policy makers should not in the near future require, trustees to offer a retirement income product or products.

These issues become more acute where products are individually tailored and the representation is that the product or suite of products is best for a specific individual where all of the facts and circumstances about that individual are not known.

But such products should not be offered in Pillar 2 because doing so is incredibly inefficient: the resources allocated to assessing the individual facts and circumstances of each member (including internal risk preferences which cannot be revealed except through professional questioning). Doing so also confuses the social policy purpose of superannuation and the appropriate limits of the policy instrument: superannuation should be responsible for maximising the inputs into the superannuation system (i.e., member, employer, and government contributions), not maximising the utility of individuals taking into account inputs *outside* of the superannuation system (i.e., their wealth outside of superannuation and personal circumstances). Superannuation is not a publicly mandated individual wealth management system.

The whole-of-life model proposed in this submission does not raise safe harbour issues because the product is screened by the Fair Work Commission based on a concept of merit that is circumscribed to superannuation inputs and superannuation outputs i.e. maximising the retirement income delivered by the superannuation system per dollar of contributions into the superannuation system only.

6. After an appropriate transition period, should the Government consider whether there should be an express obligation on trustees to offer a CIPR? If so, what length of transition period would be appropriate?

The CIPR framework suggested in the Discussion Paper is inconsistent with the evidence, and therefore inappropriate even as an approach that is optional for trustees. It would not be appropriate to mandate that trustees offer products under the framework.

7. What should the consequences be if a CIPR no longer met the minimum product requirements? Is it possible to avoid creating legacy products?

If public regulation effectively legitimises a particular superannuation product, so nudging members into that product because it is understood as meeting minimum quality criteria, then failure to meet that criteria must mean that members of that product are moved into a product that does.

However, the likely heavy reliance on life office annuities to insure longevity risk in the CIPR framework will mean members of products that no longer comply with CIPR requirements are either trapped in a new class of inefficient legacy products, or are presold into annuities that allow exit at significant cost to the income received.

The model proposed in this submission means that members of whole-of-life products that are no longer judged by the representatives of employers and employees to be of sufficient quality can be more easily transferred to another product because they are not contracted-in to a third party for-profit annuity product.

8. How can the framework facilitate trustees providing an easier transition into retirement for individuals, and what else can be done to meet this objective?

The evidence relating to for-profit provider behaviour, member engagement, financial literacy and choice-outcomes is that most new retirees will be at significant risk of being sold into poor quality products, and may be unable to leave. The availability of financial advice, much of which is sales-driven and conflicted, will not resolve this essential problem.

The public policy priority must be to connect members to the best performing funds that offer whole-of-life products that do not require choices that members are ill-equipped to make. The model we propose in this submission would achieve this. Unfortunately, the proposed CIPR framework would not.

9. What is the best way to foster competition in the CIPR market and broader retirement income product?

We do not agree that fostering competition should be an aim of public policy in the context of superannuation and retirement income products. To be beneficial, competition requires engaged and informed consumers who have the motivation and capacity to make rational long-term decisions. Those consumers do not exist to an extent that would make competition effective, and multiple government reviews have acknowledged this.

The model proposed in this submission responds to real-world consumers by means of a public-interest quality filter, applied by the representatives of employers and employees under the jurisdiction of the Fair Work Commission, which ensures members are allocated to the best funds. The evidence is that when such a public-interest quality filter has been allowed to operate, it has done so in the best interests of members.

The experience of Australia over the past 30 years has been that competition is not only irrelevant to the task of creating good quality funds and making sure members are allocated to them, but it also significantly increases costs for members and regulators.

10. Is there is a need for regulation of fees and pricing of CIPRs? What are the options?

Several members of the Actuarial Working Group have expressed concern that the CIPR framework will do little to protect members from escalating fees over the duration of CIPR membership, particularly in the context of the life office annuity component. Some in the industry have suggested that if fees were to be capped, this would act as a significant disincentive for retail funds to offer CIPRs at all.

There is a clear and irresolvable contradiction between the need to protect members in relation to fees, and the willingness of some funds to offer a CIPR if meaningful protection (such as in the form of an absolute or relative cap) was implemented.

The best way to protect members of retirement income products in relation to fees is to apply an ongoing public-interest quality filter that has projected net-retirement income as a key selection criteria. This protection is part of the model proposed in this submission.

11. Should the CIPRs framework accommodate collective defined contribution schemes?

As outlined in this submission, the member experience in a superannuation system focused on delivering retirement income should be similar to the member experience of a member of a DB plan: there is no forced point-of-sale at retirement, and instead members focus on making simple decisions about their benefits; members join products through the workplace; the product is screened by industrial parties under strong regulation of the Fair Work Commission.

The specific structures or products which would deliver that member experience will be the result of innovation. However, collective defined contribution schemes are a structure that appears to efficiently manage longevity risk and can deliver a predictable, stable retirement income stream for life. Government and private sector actuaries have tested CDCs and found them to be very efficient. It would be appropriate for policy makers to enable them to be introduced in Australia.