COMMITTEE FOR SUSTAINABLE RETIREMENT INCOMES

CSRI Submission to Government on FSI Report

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About CSRI

The Committee for Sustainable Retirement Incomes Policies (CSRI) is an independent, non-partisan, non-profit organization committed to improving the adequacy and sustainability of retirement incomes.

It pursues its mission by acting as a catalyst for public debate, and the development of evidence-based policy and advocacy.

The CSRI recognizes that the Australian system of retirement incomes has considerable strengths, but there are also significant possibilities for further improvement that could also enhance the sustainability of the system.

To achieve this aim, the Committee adopts a highly consultative approach, actively seeking contributions from all stakeholder groups and encouraging all competing viewpoints to be heard.

The Committee comprises:

Dr Michael Keating AC (Chair) - Former Secretary of Departments of Prime Minister and Cabinet, Finance, and Employment and Industrial Relations.

Dr Vince FitzGerald - Director Acil Allen Consulting, Conversation Media Group, ETF Securities Limited; Former Secretary of two Federal Departments, co-founder of Allen Consulting Group, author of the National Saving Report and a number of reports on superannuation and retirement incomes

Professor Bob Officer AM - Prof Emeritus University of Melbourne; chair of a number of fund management firms; formerly Chair of National Commission of Audit, VFMC, Victorian Work Cover and director of Bank of Melbourne and Transurban.

Ms Patricia Pascuzzo - Founder and Executive Director, former adviser to government and investment funds globally, including Australian Future Fund establishment, adviser to superannuation and pension fund boards; and Federal Treasury official.

Professor Andrew Podger AO - Former Public Service Commissioner and Secretary of Departments of Health and Aged Care, Housing and Regional Development, and Administrative Services.

Ms Elana Rubin - Director of Mirvac Group Ltd, MLC (Life and Administration & Asset Management boards) and Transurban Queensland (QML); a member of Qualitas Property Advisory Board, AICD (Victoria) and Committee for Melbourne.

For further information, please see www.csri.org.au.

Executive Summary

The retirement income system represents one of the largest sectors of the Australian economy and a significant cost to Australian taxpayers. Despite the strength of Australia's retirement income system in terms of flexibility and low direct cost to government relative to other advanced countries, there are challenges that have the potential to compromise its effectiveness and future sustainability.

The significant interaction between the superannuation, pension and tax systems suggests the need for a systems-wide perspective in shaping retirement income policies. Limits to the mandates of previous inquiries (including the FSI Report) have not been conducive to such a perspective. While the scope of the Government's proposed Tax White Paper is only now emerging publicly, it seems likely to address only the tax aspects of retirement incomes policies. So, while each of these inquiries offers scope to address some aspects of the retirement income system, what is missing is an overarching perspective. The absence of a broad perspective serves as an inhibitor on the ability of each component to achieve the purposes for which they were jointly intended.

Setting System-Wide Objectives

A related issue is that the absence of clear goals and objectives inhibits the development of policies conducive to system sustainability, as well as its efficiency and equity.

It is hard to make and sustain good policy if the public is confused about the objectives of that policy. In the case of the retirement income system there is an unfortunate lack of clearly articulated and authoritative goals and objectives. In the absence of agreed objectives it is difficult to determine whether the system is coherent and working effectively or how it could be improved. The Committee supports the FSI's recommendation for clear objectives for the superannuation system. Given the significant interrelationships between the superannuation, age pension and taxation systems, however, the Committee considers that clear overarching objectives are needed for the whole retirement income system, not just the superannuation system.

The core objectives the Committee is disposed to endorse for the system are to:

- alleviate poverty in old age; and
- facilitate the maintenance of living standards in old age (encompassing the spreading of lifetime incomes and consumption).

The primary objective of the age pension system is to alleviate poverty by providing a social safety net. The primary goal of the superannuation system is to allow income spreading through lifetimes so that people can maintain their living standards in their retirement. These two basic goals or objectives are constrained or complemented by other concerns, described as principles, including adequacy, acceptability, simplicity and certainty, and sustainability.

Consideration should be given to the mechanisms by which theses objectives and principles, which by their very nature will be fairly broad, are to be achieved through specific policy development and implementation processes. The Committee recommends that once the objectives and principles are agreed, a process is needed to:

- evaluate the system against these principles and objectives to identify priority areas for reform and broad policy design; and
- develop a blueprint for reform and a transition path for implementation.

The process for developing the objectives/principles and developing the system blueprint needs to engage broadly with industry, government and community stakeholders. A consultative process would allow alternative perspectives to be brought to bear and critical considerations to be identified thereby engendering broader and more enduring community support for the resulting outcomes.

The CSRI sees merit in the establishment of an independent Committee to be charged with advising the government on the establishment of an overarching policy framework and blueprint for reform of the retirement income system. Its members would be appointed in a personal rather than representative capacity; and should be selected on the basis of independence, experience, expertise, and diversity. Its approach would be highly consultative and transparent and it would have the ability to obtain information relevant to its work from the relevant government agencies and independent regulators.

Recommendation 1: Setting system-wide objectives - Clear overarching objectives are needed for the whole retirement income system, not just the superannuation system. Articulation of goals and measurable objectives that are then recognized by government, would provide a framework to guide future policy development and ensure the coherence of the whole system is achieved and maintained.

Recommendation 2: Articulation of objectives - That consideration be given to the articulation of retirement income system objectives to:

- alleviate poverty in old age; and
- facilitate the maintenance of living standards in old age (encompassing the spreading of lifetime incomes and consumption).

The primary objective of the age pension system is to alleviate poverty by providing a social safety net. The primary goal of the superannuation system is to allow income spreading through lifetimes so that people can maintain their living standards in their retirement.

These two basic goals or objectives are constrained or complemented by other concerns, described as principles, including adequacy, acceptability, simplicity and certainty, and sustainability.

Recommendation 3: Independent Review of the Retirement Income System - An independent Committee be established to undertake a holistic review of the retirement income system on a consultative basis, engaging broadly with industry, government and community stakeholders, with the purpose of:

- seeking broad community and bipartisan support for a set of retirement income objectives and principles;
- evaluating the retirement income system against these objectives and principles to identify priority areas for reform; and
- advising government on the development of a blueprint for reform and a transition path for implementation.

Committee members would be appointed in a personal rather than representative capacity; and should be selected on the basis of independence, experience, expertise, and diversity.

Post Retirement Income Arrangements

The Committee considers that the development of the post-retirement arrangements is a priority for reforming Australia's retirement income system. Reform options need to provide an appropriate balance between providing individuals with the flexibility to plan their own retirement while ensuring that superannuation benefits are used for the purpose for which they were intended – to provide financial security in retirement.

To this end the Committee supports the Treasury's review of retirement income stream regulation and its focus on eliminating barriers to the use of income stream products to better manage longevity risk. Proposed measures would need to be evaluated on their ability to provide retirees with greater flexibility to take up income stream products that better manage longevity risk, while also ensuring that superannuation is used for legitimate retirement income purposes. The relative merit of the options that Treasury has canvassed in achieving these aims requires much careful consideration.

The Committee endorses the FSI's recommendation to require trustees to provide a Comprehensive Income Product for Retirement (CIPR) as it would help address the challenge that many retirees face in transitioning to the retirement phase of superannuation. While the concept of the CIPR has much to commend it, its ability to deliver improved retirement outcomes will depend largely on how well it delivers products appropriate for a large proportion of people and their changing circumstances as they move through retirement. A design strength of a CIPR is that it is not necessarily one but a combination of income products providing greater flexibility to meet these varying needs. The CIPR has the potential to offer greater flexibility than a default option as retirees must opt in before the investment is made. As such, it reduces the risk of retirees being placed automatically into products that are unsuitable for their needs. On the other hand, whether the compulsion to offer CIPRs will lead to most retirees having appropriate insurance against longevity risk and to using their savings for genuine retirement purposes without excessive reliance on the age pension is as yet unproven.

Accordingly after the implementation issues have been resolved and there has been some time to see how it performs, consideration could be given to elevating the CIPR to the status of a default system. The design and development of the CIPR should be carried out with an eye to its ultimately being made the post retirement default option.

Recommendation 4: Comprehensive Income Product for Retirement - The Committee endorses the FSI's recommendation to require superannuation fund trustees to pre-select an option for members to receive their superannuation benefits in retirement with take up of the option by the member to be on an opt-in basis. The design and development of the comprehensive income product for retirement should be carried out with an eye to its ultimately being made the post retirement default option.

Recommendation 5: Eliminating impediments to the use of income stream products to better manage longevity risk - Proposed measures ought to be evaluated on their ability to provide retirees with greater flexibility to take up income stream products that better manage longevity risk, while also ensuring that superannuation is used for legitimate retirement income purposes.

Taxation of Superannuation

The Committee supports the better targeting of superannuation concessions to meet the system's objectives. There is a range of measures that ought to be evaluated to achieve a better targeting of concessions. The Committee's view, however, is that such options ought to be considered as part of a broader review of retirement income policies that would enable holistic consideration of a broader set of levers to better address the following factors:

- Level and distribution of tax concessions – There is a strong theoretical case for treating superannuation savings on a comprehensive consumption tax basis when the benefits are consumed but that is not a practical option for Australia today given the legacy of superannuation tax arrangements in place. Equally, however, the idea that superannuation should be taxed in the same way as other non-housing savings on a full marginal tax rate basis is inappropriate given the objective of facilitating the smoothing of lifetime incomes. An intermediate option could ensure a more equitable distribution within the context of the current level of tax concessions.
- Targeting – Very large balances may currently be used for purposes other than retirement incomes, may attract tax advantages and may potentially also allow access to the age pension. Firmer requirement to direct superannuation savings towards genuine retirement purposes and/or limit tax advantages when balances exceed some cap may ensure better targeting.
- Simplification – The system has been subjected to frequent changes resulting in high system complexity. Rather than adding more requirements to an already complex system, the

opportunity should be taken for a broader review to identify solutions that reduce, rather than add, to overall system complexity.

- Alignment – Holistic review of the retirement income system would enable a better alignment of the individual components with the overarching objectives of the system e.g. the operation of the means test might be reviewed to ensure it takes sufficient account of the increasing level of superannuation savings (and other assets) that could and/or should be used for retirement income purposes.
- Implications for the wide variations in personal circumstances – The system arrangements need to support adequate retirement incomes for people in different circumstances including those with interrupted work patterns. The evidence shows that women hold a disproportionate amount of the low account balances in the system reflecting extensive periods in non paid work. Similarly, there are wide variations in the way people can or choose to transition into retirement. A broader review could give consideration to the set of measures that might best address such variations in circumstances.

Recommendation 6: Issues to be considered as part of a broader review of the retirement income system - The consideration of measures to better target superannuation concessions ought to be considered as part of a broader review of retirement income policies (as suggested in Recommendation 3) that would enable holistic consideration of a broader set of levers to better address the following factors:

- Simplification -identifying solutions that reduce, rather than add, to overall system complexity.
- Alignment -of the individual components of the retirement income system with the overarching objectives of the system such as the operation of the means test and whether it takes sufficient account of other assets and any wider capacity for people to direct their superannuation savings into income stream products.
- Implications for the wide variations in personal circumstances - measures that might best address variations in circumstances including people with interrupted work patterns.

Efficiency in the Accumulation Phase

The compulsory and concessional nature of superannuation creates a greater obligation on government to ensure that the superannuation industry operates efficiently. Given its importance, the Committee supports the proposal for a review of the efficiency of the industry by 2020 after the *MySuper* reforms have been bedded down and have had sufficient time to operate. The Committee considers that such a review would need to investigate whether competitive pressures in the industry are sufficient to stimulate the drive to efficiency, and if not, why not.

Based on the outcome of the above investigation, the review should also examine whether some form of government intervention is called for. In doing so, alternative reform options would need to be evaluated on a benefit cost basis. While the FSI has raised the option of a new superannuation member auction scheme, alternative options should also be evaluated including measures aimed at improving the fragmented structure of the industry. The case for government intervention would be on both: evidence of the absence of competition leading to socially inefficient outcomes; and the efficiency gains from the proposed government reform more than out weighing the inevitable costs of such intervention.

Recommendation 7: Review of Superannuation Industry Fragmentation - That the FSI proposal review of the efficiency of the superannuation industry by 2020 (after the effects of the *MySuper* reforms have had a chance to work their way through the system) should investigate whether competitive pressures in the industry are sufficient to stimulate the drive to efficiency, and if not why not. Alternative reform options ought to be evaluated on a benefit cost basis including measures aimed at improving the fragmented structure of the industry.

1. Introduction

The Committee's response to the FSI Report, is focused on four key areas:

- Objectives of the superannuation system;
- Post retirement income system;
- Taxation of superannuation; and
- Efficiency and competition in the accumulation phase.

The following submission outlines the Committee's conclusions and recommendations in each of these areas.

2. Objectives of the Superannuation System

The Committee supports the FSI's recommendation for clear objectives for the superannuation system. However, given the significant interrelationships between the superannuation, age pension and taxation systems, the Committee considers that clear overarching objectives are needed for the *whole* retirement income system. Any specific objectives set for the superannuation system would therefore need to be consistent with these overarching retirement income objectives. The Committee's views on the development of objectives for the retirement income system are outlined below.

Retirement Incomes System

FSI Recommendation 9: Set clear objectives for the superannuation system.

A clear statement of the system's objectives is necessary to target policy settings better and make them more stable. Clearly articulated objectives that have broad community support would help to align policy settings, industry initiatives and community expectations.

There have been previous attempts to establish clear goals for superannuation. In 2013, the then government set up the Charter Group to develop and recommend a Charter of Superannuation Adequacy and Sustainability that would serve to guide all future changes to the superannuation system consistent with the principles of certainty, adequacy, fairness and sustainability.

> *"During the consultation process, it became obvious that there is a range of views on what super is for. Some see its purpose as alleviating poverty (not a widely held view) while some see super more as wealth-building and even as building intergenerational wealth. The great bulk of opinion is somewhere in the middle; that is, that super is intended to provide more dignity in retirement, giving people a standard of living above the safety net afforded by the Age Pension." (Super Charter Group, 2013).*

This Committee suspects there may also be some public confusion concerning the purpose and objective of the age pension system, notwithstanding the much longer history of the system.

It is hard to make and sustain good policy if the public is confused about the objectives of that policy. In the case of the retirement income system there is an unfortunate lack of clearly articulated and authoritative goals and objectives. Furthermore, articulation of goals and measurable objectives for the whole retirement income system, including superannuation, which are then recognized by government, would assist in providing a framework to guide future policy development and ensure the coherence of the whole system is achieved and maintained. This development of retirement incomes policy goals and objectives should be cognizant of the rationale for government intervention, taking into account relevant market failure and government failure arguments and sound public policy principles of efficiency and equity.

While there is no authoritative official framework of goals and objectives, there does seem to be a reasonable amount of common ground among the experts. For example, the Retirement Income Consultation Paper (AFTS 2008) identifies five objectives for assessing a retirement income system, namely:

- it should be broad and adequate, in that it protects those unable to save against poverty in their old age and provides the means by which individuals must or can save for their retirement;
- it should be acceptable to individuals, in that it considers the income needs of individuals both before and after retirement, is equitable and does not bias inappropriately other saving decisions;
- it should be robust, in that it deals appropriately with investment, inflation and longevity risk;
- it should be simple and approachable, in that it allows individuals to make decisions which are in their best interests; and
- it should be sustainable, in that it is financially sound and detracts as little as possible from economic growth.

Similarly, the Charter Group (2013:1) concluded that, at a high level, the objectives of the Australian superannuation system are to:

- provide an adequate level of retirement income;
- relieve pressure on the Age Pension; and
- increase national savings, creating a pool of patient capital to be invested as decided by fiduciary trustees.

The FSI Report suggested that the specific objective of the superannuation system is "*To provide income in retirement to substitute or supplement the Age Pension*" (Financial System Inquiry Report 2014,p 95). It further proposed a number of sub-objectives, namely to:

- facilitate consumption smoothing over the course of an individual's life;
- help people manage financial risks in retirement;
- be fully funded from savings;
- be invested in the best interests of superannuation fund members;
- alleviate fiscal pressures on Government from the retirement income system; and
- be simple and efficient, and provide safeguards.

This Committee for its part is inclined to follow the lead of the FSI and propose only a limited number of core objectives for the retirement incomes system, but that these should then be supported by a number of principles that would guide progress towards the basic goals. The two basic goals, which this Committee is disposed to endorse, were proposed by Podger, Stanton and Whiteford (2014) and are very similar to the single objective proposed by the FSI and the first objective in the AFTS Consultation Paper. Specifically they are to:

- alleviate poverty in old age; and
- facilitate the maintenance of living standards in old age (encompassing the spreading of lifetime incomes and consumption).

These two basic goals or objectives would then be constrained or complemented by other concerns, described as principles, including adequacy, acceptability, simplicity and certainty, and sustainability.

These two objectives are closely aligned to the two main components of the retirement incomes system, the age pension and superannuation arrangements.

> Age Pension Goals – the primary objective of the age pension is to alleviate poverty by providing a social safety net. Consistent with this objective, access to the age pension in Australia is targeted at those with the greatest need. This targeting is implemented on the basis of means testing taking into consideration both income and assets. The means test balances the desire to concentrate assistance on those in most need with the desire to retain

rewards for saving and working, resulting in most Australians receiving a full or part age pension.

Superannuation Goals – the primary goal of the superannuation system is to facilitate income and consumption spreading through adult lifetimes so that they can maintain their living standards in their retirement. This income spreading need not be the sole source of income in retirement; the expectations of the original architects of the system was that for the majority of retirees, their superannuation benefits were expected to be supplemented by access to a part-age pension.

Importantly, a focus on these two core objectives might temper suggestions that the system pursue other goals:

- the superannuation system is not primarily about wealth creation, though facilitating the spreading of lifetime earnings and consumption implies a degree of wealth accumulation through the impact of long-term investments and compound interest;
- the superannuation system is not primarily about increasing national savings or providing a source for financing infrastructure, though it may contribute to these consistent with the core objectives;
- superannuation is not intended to address non-retirement consumption purposes such as housing or parenting costs, though the case for compulsory contributions may be weaker when immediate consumption needs are significant; and
- tax support for superannuation is not primarily about reducing expenditure on age pensions, though the combined cost of support for superannuation and age pensions needs to be affordable and sustainable.

Developing a set of overarching objectives and principles for the retirement income system is therefore an important first step towards targeting policy settings better and making them more stable. Consideration would need to be given to the mechanisms by which these agreed objectives and principles, which by their very nature will be fairly broad, are given effect through policy development and implementation processes. The Committee is firmly of the view that there would also need to be a comprehensive evaluation of the retirement income system against these objectives and principles to identify priority areas for reform; and ultimately the development of a blueprint for reform and a transition path for implementation. To facilitate the development of enduring bipartisan support, the process for developing the above needs to engage broadly with industry, government and community stakeholders to allow alternative perspectives to be brought to bear and all the critical considerations to be identified and taken into account.

The primary consideration is whether an independent body is needed with responsibility for ensuring that policy development is pursued consistently with retirement income objectives. The Superannuation Charter Group Report (2013) recommended the establishment of an independent body to be responsible for ensuring an objective examination of proposed changes and to discourage the hurried implementation of 'urgent changes'. If such a body is established, further considerations are:

- nature and extent of its responsibilities and necessary powers to ensure that it can be effective including how it will be funded, the limits of its specific powers; and
- community consultation processes.

The Superannuation Charter Group report (2013) provides a good starting point for consideration of the alternative models for the creation of this body. This Committee is attracted to the body being established with the following key features:

- independence from government;
- advisory role rather than regulatory powers;
- ability to obtain information relevant to its work from the relevant government agencies and independent regulators;
- members to be appointed in a personal rather than representative capacity; and selected on the basis of independence, experience, expertise, and diversity; and
- transparent and consultative processes.

Once developed and agreed, the important elements of these objectives and principles might best be enshrined in legislation to give them clear and ongoing authority, to identify reform priorities and to form the basis for regular evaluation. A blueprint for reform and a transition path would be something that the oversight body would seek to develop on a consultative basis, based on an evaluation of the system against the objectives/principles, identification of priority areas for reform and broad policy design.

Recommendation 1: Setting system-wide objectives - Clear overarching objectives are needed for the whole retirement income system not just the superannuation system. Articulation of goals and measurable objectives that are then recognized by government, would provide a framework to guide future policy development and ensure the coherence of the whole system is achieved and maintained.

Recommendation 2: Articulation of objectives - That consideration be given to the articulation of the objectives the retirement income system to:

- alleviate poverty in old age; and
- facilitate the maintenance of living standards in old age (encompassing the spreading of lifetime incomes and consumption).

The primary objective of the age pension system is to alleviate poverty by providing a social safety net. The primary goal of the superannuation system is to allow income spreading through lifetimes so that people can maintain their living standards in their retirement.

These two basic goals or objectives are constrained or complemented by other concerns, described as principles, including adequacy, acceptability, simplicity and certainty, and sustainability.

Recommendation 3: Independent Review of the Retirement Income System - An independent Committee be established to undertake a holistic review of the retirement income system on a consultative basis, engaging broadly with industry, government and community stakeholders, with the purpose of:

- seeking broad community and bipartisan support for a set of retirement income objectives and principles;
- evaluating the retirement income system against these objectives and principles to identify priority areas for reform; and
- advising government on the development of a blueprint for reform and a transition path for implementation.

Committee members would be appointed in a personal rather than representative capacity; and should be selected on the basis of independence, experience, expertise, and diversity.

3. Retirement Phase of Superannuation

3.1 Assessment of the Current Arrangements

While superannuation generates self-funded assets for retirement by mandating and encouraging contributions, a key weakness of current Australian arrangements is that they do not effectively ensure that those assets are used for income purposes throughout the years of retirement. There is no limit on lump sum benefits and, while retirement income streams are encouraged, there is no incentive for lifetime annuities and considerable amounts are left apparently unintentionally in estates. This sits in sharp contrast with both the age pension and the benefits provided in most overseas national systems that are only in the form of lifetime annuities or lifetime annuity-like income streams.

Under our current arrangements, the long-term risks related to inflation, investment and longevity are left to individuals, with the publicly provided age pension acting as a minimum income guarantee. Since the life annuity market is very small, the main ways superannuation savings are used to support retirement are phased withdrawal products and lump sum withdrawals invested in the family home (Bateman and Piggott, 2010). As people live longer, there is a growing risk that individuals will exhaust their assets before they die. So far, however, the greater problem seems to be that high levels of self-insurance result in retirees living overly frugally, or unintentionally leaving large superannuation savings to their estates. It also appears that in some cases superannuation balances are deliberately accumulated so that they can be left as a tax sheltered bequest by the superannuant.

The current high level of self insurance has partly been attributed to behavioural biases that individuals experience. These biases affect the accumulation phase with many people under-saving relative to what they would later consider to be adequate for retirement. Behavioral biases may partly be explained not only by lack of competence but also by:

> *"inertia, confusion, short-termism, and lack of self-control. There is evidence that even when people understand that they are saving too little for retirement, they cannot manage to increase their saving simply by choosing to do so."* (CEPAR Submission to the FSI Inquiry, June 2014 pxx)

Behavioural biases do not end at retirement: their effect continues throughout the phases of retirement. There seems, for example, widespread misunderstanding that longevity risk is best managed not by pooling resources through an insurance product, but by self-insurance and reliance on the age pension.

Another factor said to contribute to the high degree of self-insurance during retirement is the lack of products that retirees can purchase to insure against longevity risk. The Henry Review (2009) identified this as a structural weakness in the system and raised the need for better retirement income products to ensure an income higher than the age pension throughout their retirement.

In formulating policies for the post retirement phase, the government would need to balance a number of conflicting considerations. On the one hand, the concessional nature of superannuation assets warrants some form of government intervention to ensure that those assets are used for genuine retirement incomes purposes. This may be thought of as the efficiency of the system to target retirement incomes. On the other hand, the needs of individuals vary greatly at retirement and it is appropriate that they maintain some flexibility in how they access and invest their post retirement assets. There is therefore a trade-off to be struck between efficiency and flexibility in designing an appropriate post retirement system.

In developing post retirement policies, a range of demand and supply side responses is possible starting from the least interventionary option of eliminating barriers to the supply and take-up of income stream products, through to the provision of incentives, and ultimately to some form of mandatory requirement. The following section evaluates the FSI recommendations within the broader context of the spectrum of responses possible.

3.2 Possible solutions

The policy options included in the following discussion are:

- Mandating specific retirement income products (in full or in part, or for later stages of retirement).
- Providing policy incentives that encourage retirees to purchase retirement income products that help manage longevity and other risks.
- Requiring superannuation trustees to pre-select a CIPR for members: as recommended by the FSI Panel.
- Removal of impediments to retirement income product development: as recommended by the FSI Panel.
- Supply side intervention to facilitate the development of income stream products by the private sector.

3.2.1 Mandating Requirements

Government intervention to better address longevity risk could involve mandating minimum income streams and/or limiting lump sums. This approach would overcome one of the key problems inhibiting the development of an annuities market. Market failure may arise because individuals tend to have more information on how long they are likely to live than insurers do. This may mean that only people who consider they are likely to live longer than average purchase these products. Insurers can react to this 'information asymmetry' either by not selling the products or by pricing them at such a level that most people are discouraged from purchasing them. The problem of 'adverse selection' may be overcome using a mandatory approach by ensuring that the people in the insurance pool reflect the average life expectancy within the community as a whole.

However, as highlighted by the Henry Report (2009), mandating the purchase of longevity insurance overcomes this market failure by imposing a cost on people who are in poor health or have lower life expectancies, such as Indigenous Australians. Such people would be disadvantaged by a mandatory system as they would effectively be subsidizing people who live longer than average. This is accepted in overseas social insurance schemes where individuals do not directly accumulate their own savings but rather have an entitlement defined only in terms of a lifetime retirement pension.

While a mandatory approach would reduce the risk that people exhaust their assets quickly in order to receive an Age Pension, research suggests that people in retirement are conservative in how they draw down their assets (Lim-Applegate et al., 2005).

A number of submissions to the FSI raise a number of difficulties associated with mandating certain lifetime annuity products (such as CEPAR, 2015b), including:

- Difficulties associated with accounting for widely differing individual circumstances of retirees through a mandatory product;
- Considerable timing risk in mandating a large sum at a single point in time as the annuity purchase may be at a time when interest rates are low and the value for money poor; and
- Uninsurable risks to which people in retirement may be exposed are many, while mandatory annuitisation gives precedence to managing longevity risks over all other risks.

On the other hand, failure to insure against longevity risk leaves people either running out of savings or under-utilising their savings, the former leading to over-reliance on the age pension. There are also ways in which the difficulties mentioned above may be eased, particularly through deferred lifetime annuities.

Deferred life annuities have certain benefits over immediate life annuities as a default:

- Private information, or information asymmetry, between buyer and seller concerning the circumstances of most individuals projected 20 or 25 years into the future is limited at the point of retirement.
- The mortality bonus inherent in a deferred annuity purchased at retirement and payable at a later stage (such as age 85) would potentially make the product more affordable.

- Timing risk could be reduced by setting up deferred annuity purchases as a stream of annual payments either before or after retirement.

Overall however mandating annuities provides individual retirees with limited flexibility to design their retirement to better meet their individual needs and circumstances.

3.2.2 Default post retirement product

A default retirement income structure could be designed to deliver consumption smoothing and coverage against a standard list of risks, in a way that would be suitable for the majority of the retiring population. Such risks could include: investment, inflation, longevity, purchase timing, and counter-party risk. Where the individual forms the judgment that they can better meet their post retirement needs through some other arrangement, they would have the ability to opt out of the default.

The World Bank recommends

> "*countries that offer a constrained choice to retiring workers and do not mandate the use of a single retirement product for all should also specify the product that will be used as the default option. This will help workers who are unable or unwilling to make a decision on their own and will protect them from abusive selling practices of brokers and selling agents of providers*" (Rocha, R and Vittas, D 2010).

While there is scant evidence on the operation of defaults in the post retirement phase, the limited evidence that does exist suggests that defaults may be effective. In a study of retirement income choice in Switzerland, Butler and Teppa (2007) find that most retirees adopt annuities where that is the default, or lump sums where that is the default.

Depending on the design of defaults, they may share some of the limitations associated with mandatory annuitisation outlined above, in terms of cost, timing risk and difficulty of meeting the needs of heterogenous member groups. A default's effectiveness depends largely on the degree of flexibility it provides to meet the needs of the individual retiree. Sunstein (2013) distinguishes between impersonal defaults that have many of the disadvantages of mandatory annuities, and personal defaults.

The critical benefit of a default over mandate is that there is at least an out – it is possible for the retiree to override the default. Tailoring to individual circumstances in accumulation phase default options is normally limited only to age and account balances, if at all. If this is indicative of the degree of tailoring that would be possible in the post-retirement phase, it would suggest that the market needs further development before it would be able to implement a default post retirement income stream option with flexibility to meet the varying needs of retirees.

3.2.3 Comprehensive income product

In making recommendations relating to the post retirement phase, the FSI Panel considered and rejected both a mandate and a default post retirement solution before settling on its recommendation of a Comprehensive Income Product for Retirement (CIPR). A CIPR offers the potential to achieve some of the core benefits of mandate and defaults while reducing many of the downsides as outlined above.

In particular, the benefits that the CIPR shares with both default and mandatory annuitisation include:

- assisting to overcome some of the behavioural biases that compound the complexity of retirement decisions, such as decision-making that disproportionately focuses on the short term;
- helping to address the challenge that many retirees face in transitioning to the retirement phase of superannuation. Retirees are currently highly reliant on affiliated financial advisers in navigating post retirement choices. The quality of such advice has been demonstrated to vary significantly.
- Enabling trustees to provide a form of guidance in making sound retirement decisions, rather than the individual member being solely responsible and on their own.

A design strength of CIPR is that it is not necessarily one but a combination of income products. Research has shown that full annuitisation of super savings is not necessarily an optimal drawdown strategy for an individual (Hanewald, Piggott and Sherris 2013) as retirement can last for several decades, and exposure to market risk is necessary to ensure that inflation does not erode savings. Certain product types, such as variable annuities with equity exposures and insurers' guarantees have had limited success in other markets because they are often difficult to price and the hedging of risks is difficult. Options such as keeping market risk with the individual via an account based pension combined with a deferred annuity product to cover longevity risk, as discussed in Bateman, Kingston et al (2001) may be catered for within a CIPR.

A CIPR provides greater flexibility than a default – the investment is not made until the retiree has approved it. As such, it reduces the risk of retirees being placed automatically into products that are unsuitable for their needs.

On the other hand, while the concept of the CIPR has much to commend it, its ability to deliver improved retirement outcomes will depend largely on how it is implemented and received. Potential CIPRs should be assessed according to a number of criteria including:

- Their ability to trade off the various risks (investment, inflation, longevity) that retirees will face through retirement. While products such as annuities may cover longevity risk, the individual may instead face risks related to liquidity or timing of purchase.
- Their ability to deliver consumption smoothing between working life and retirement dynamically tailored to phases of retirement so that products will be appropriate for a greater proportion of people and the changing circumstances that they face moving through retirement. For example, individuals in early retirement tend to be more concerned with liquidity while in later retirement longevity risk becomes prominent.
- The extent to which individuals do indeed take up the products.

Over time, once there has been some experience with the design and application of a CIPR, it may be possible to evolve the CIPR into a post retirement default option. The market needs further experience in designing income stream solutions to better address longevity risk while meeting the varying needs of retirees before it would be advisable to require a post retirement default option. On this basis, there would be considerable merit in designing the CIPR with an eye to its future evolution to a default option.

Recommendation 4: Comprehensive Income Product for Retirement - The Committee endorses the FSI's recommendation to require superannuation fund trustees to pre-select an option for members to receive their superannuation benefits in retirement with take up of the option by the member to be on an opt-in basis. The design and development of the comprehensive income product for retirement should be carried out with an eye to its ultimately being made the post retirement default option.

3.2.4 Eliminating Impediments

The objective of the current regulatory regime in the retirement phase is to ensure that the capital underpinning a retirement product is drawn down over time. The underlying purpose of these restrictions is to prevent the use of tax-advantaged retirement income as a wealth accumulation vehicle rather than to facilitate the provision of retirement income (Treasury 2015).

However regulatory and other policy impediments are having the unintended consequence of inhibiting the development of retirement income products (including deferred lifetime annuities and group self-annuitisation schemes). The Committee supports the review by Treasury of retirement income stream regulation that is examining ways to reduce or remove such barriers. The focus of this review is correctly on eliminating any barriers to the use of income stream products to better manage longevity risk.[1]

[1] The key areas of focus by the Treasury review of income stream products are: Broadening the annuity and pension rules to reduce the limits they place on the range of products available on the market and allow for product innovation; Expanding the options for purchasing income

Proposed measures need to be evaluated on their ability to provide retirees with greater flexibility to take up income stream products to better manage longevity risk, while also ensuring that superannuation is used for legitimate retirement income purposes. The relative merit of the options that Treasury has canvassed in achieving these aims effectively requires much careful consideration.

It is however recognised that eliminating barriers to the take-up of income stream products can only go so far in improving retirement income outcomes. As previously mentioned, a range of behavioral biases and the absence of suitable income stream products impede the use of income stream products that need to be overcome for better longevity risk management.

Recommendation 5: Eliminating impediments to the use of income stream products to better manage longevity risk - Proposed measures ought to be evaluated on their ability to provide retirees with greater flexibility to take up income stream products that better manage longevity risk, while also ensuring that superannuation is used for legitimate retirement income purposes.

3.2.5 Supply Side Options

The lack of products that guarantee an income over a person's retired life represents a structural weakness in the system. There is a strong case for new products to be developed and made available that would allow people to insure against the risk of exhausting their assets before they die. While the development of such products should remain the domain of the private sector, there have been previous suggestions that some form of government intervention ought to be considered to supplement the private sector provision. While these matters are not explicitly addressed in the final FSI Report, the Committee saw value in revisiting the case for government supply side intervention before drawing a conclusion.

In considering the possibility for government supply-side intervention, the main concern is whether the longevity risk is too complex, and subject to such uncertain and ongoing change with population changing, that the market is not able to offer insurance products at an acceptable price. The same type of concern led to the introduction of indexed bonds in the 1980s, allowing the market to avoid the risk of unanticipated inflation without the need for more direct government intervention.

A direct method to support the supply of retirement income products would be for government to participate in the market by issuing long dated financial instruments that help to manage longevity and related risks. These could take the form of longevity, infrastructure, and inflation linked bonds, allowing the private sector to better deal with the risk accumulating on the balance sheets of reinsurers and lowering the cost of risk capital. Henry (2009) was supportive of a limited government role in facilitating the development of longevity risk management products, with a significant proviso:

> *The government should support the development of a longevity insurance market within the private sector (a) The government should issue long-term securities, but only where this is consistent with its fiscal obligations, to help product providers manage the investment risk associated with longevity insurance* (Henry 2009, p 121).

Another possible form of government intervention raised previously is the direct provision of longevity insurance products to consumers that could, for example, be provided through buying additional age pension income. However, this option would involve the government taking on more longevity risk when it already bears a large exposure particularly through the provision of the age pension, health and aged care. Henry (2009) raised concerns with suggestions of the government offering for sale lifetime annuities, noting that this option would need to be:

> *"subject to a business case that ensures the accurate pricing of the risks being taken on by the government. To limit the government's exposure to longevity risk, it should consider*

stream products to via multiple premiums via an existing product eg an account based pension. Changes to the minimum drawdown rules to address concerns about retirees potentially running out of capital.

placing limits on how much income a person can purchase from the government." (Henry 2009 p121).

The CSRI considers that there should be more product innovation in the development of longevity risk management products and that this should remain the domain of the private sector. The measures to eliminate demand side impediments as outlined in the previous sections should be implemented and allowed to work before consideration should be given to the need for any further supply side interventions.

3.2.6 Conclusions relating to post retirement system

The Committee considers that the development of a clear preferred post retirement system is a priority area of reform. If super tax concessions are provided, then the accumulated superannuation balances should be used for retirement income purposes (consistent with the objectives of the system). Policies encouraging or requiring a person to invest their superannuation in particular types of product, or restricting access to lump sums, should be adopted if there is strong evidence that people are unable to make decisions that are in their best interests and consistent with the system's objectives. The post retirement system needs, however, to retain sufficient flexibility to allow product innovation and allow retirees to better manage their incomes throughout retirement.

The Committee endorses the need to remove impediments to retirement income product development and take up. To this end the Committee supports the review by Treasury of retirement income stream regulation focus on eliminating any barriers to the use of income stream products to better manage longevity risk.

Proposed measures would need to be evaluated on their ability to provide retirees with greater flexibility to take up income stream products to better manage longevity risk, while also ensuring that superannuation is used for legitimate retirement income purposes. The relative merit of the options that Treasury has canvassed in achieving these aims effectively requires much careful consideration.

The Committee is inclined to endorse the FSI's recommendation to require trustees to provide a CIPR believing this option may provide an appropriate balance between providing individuals with flexibility to plan their own retirement while offering a way for ensuring individuals can use their superannuation benefits for the purpose for which they are intended – to provide financial security in retirement.

After the CIPR's implementation issues have been resolved and there has been some time to see how it performs, consideration could then be given to elevating the CIPR to the status of a default system particularly if in fact few avail themselves of CIPRs. The design and development of the CIPR should be carried out with an eye to its ultimately being made the post retirement default option.

4. Taxation of superannuation

FSI Observation:

The Tax White Paper should consider the removal of tax barriers to a seamless transition to retirement and target superannuation tax concessions to the superannuation system's objectives. Adjustments to tax settings and efforts to improve equity have been major contributors to superannuation policy change in the past. The Inquiry believes community concerns about these issues need to be addressed to achieve greater policy stability and long-term confidence and trust in the system.

Assessing the fairness of the retirement income system is a highly complex exercise that needs to take into account interactions with the broader tax and transfer system. Further, as highlighted by Henry (2009):

> *"the assessment should consider the outcomes for individuals and families over their lifecycle and between generations, including between future retirees and those taxpayers who will be funding the Age Pension and other publicly provided benefits. Basing the assessment on a subset of policy settings at a point in time may be misleading (Henry 2009, p27).*

Superannuation contributions and earnings are taxed at a flat 15% rate for all income earners. This represents a concessional rate for most income earners and could be said to address the bias in the income tax system that favors current consumption over savings.

The size of the super concession provided (per dollar earned) is skewed to high income earners whose marginal income tax is substantially above the 15% contributions tax (though this has been moderated in part by the 30% rate applying to contributions by those earning more than $300,000 a year). Some low income earners in receipt of income support or family payments also receive above average concessions (per dollar earned) because they face high effective marginal tax rates and the superannuation guarantee contributions are not included as income for the purposes of determining eligibility for these benefits.

On the other hand, for low-income earners on the lowest tax rate who do not receive income support, the 15% contributions and earnings tax provides little if any concession (for those below the tax threshold, there is a tax penalty except for the modest co-contribution that may be payable).

Discretionary superannuation contributions by low-income earners provides small if any concession regardless of whether they receive income support. This is because the income support means tests include salary-sacrificed superannuation contributions in the definition of income.

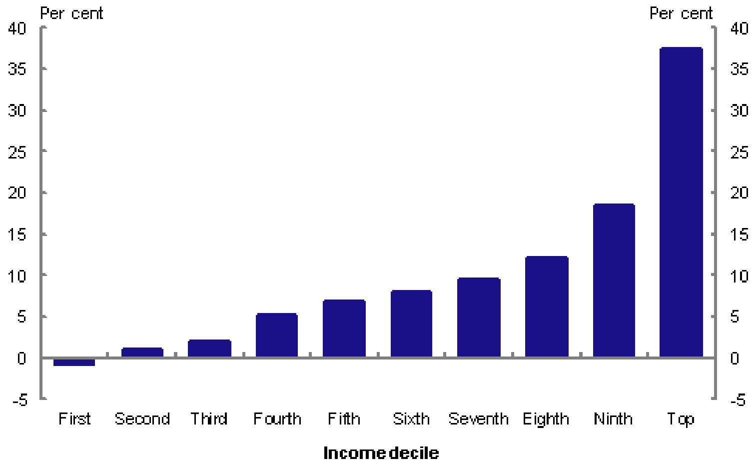
Measuring the tax concessions, or tax expenditures, for superannuation is not straightforward. Currently contributions and earnings are taxed at 15% but benefits are tax-free. Treasury's standard approach is to measure the cost to revenue as the difference between the tax on contributions and earnings compared with the total tax payable if these were treated the same way as personal income from which most other savings are made: that is, were contributions treated as income and taxed at individuals' marginal rates, and earnings in superannuation accounts similarly taxed. This benchmark approach is called a 'comprehensive income' basis or TTE (full tax on contributions and earnings, and no tax on final consumption of the savings). On this basis, the tax expenditures for superannuation are nearing $30 billion a year. Treasury also produced a second estimate last year based on a 'comprehensive consumption' tax basis, or TEE, where contributions are taxed fully at marginal rates but the investment return is exempt as is final consumption. This is the way housing investment is taxed and leads to a figure of around $12 billion in tax expenditures.

A third approach, which would reflect the most common treatment of superannuation internationally whether through defined benefits or defined-contributions schemes, is to exempt both contributions and any investment earnings but to tax in full the income derived in retirement (EET). This is consistent with the concept of spreading lifetime earnings. No official estimate is available, but compared to such an approach, current arrangements would cost much less than $12 billion, though the figure would increase substantially in the future as the superannuation system matures and retirement incomes increase (and the population ages). The figure would be less than under the comprehensive consumption approach because the marginal rate applying would be lower (contributions are made when people have substantial earned income while benefits are received when people have lower if any other income).

There is no right or wrong way of measuring the tax concessions: each one has validity for different purposes. Superannuation savings are favored over other forms of saving. But if the underlying purpose is to facilitate the spreading of lifetime earnings, the appropriate benchmark would be EET, suggesting that the budgetary savings from limiting the tax concessions would be relatively small albeit still important for the sustainability of the system overall. The *quid pro quo* for an EET approach is, as discussed further below, that the savings are genuinely spread over the lifetime and consumed (and taxed) in retirement.

Whichever benchmark is used for estimating tax concessions, current arrangements strongly favour higher income groups. The size of the tax benefit that the superannuation tax confers relative to the treatment of other earnings favors higher income earners with higher marginal tax rates and a greater capacity to undertake voluntary savings. Various distributional analyses (AFTS 2009; Tellis 2009) of this aggregate amount have drawn the clear conclusion that the superannuation arrangements strongly favour high income earners as they make the most of the concessional contributions, receive the bulk of tax concessions on earnings and also receive a higher tax saving per dollar of contributed benefits as shown in Chart 1.

Chart 1: Share of total superannuation tax concessions by income decile



Source: FSI Report 2014.

The Committee supports the better targeting of superannuation concessions to meet the system's objectives. Options that ought to be carefully evaluated include:

- taxing contributions at marginal rates minus a percentage point rebate as proposed by the Henry Report (2009);
- applying the 30% tax on contributions on high income earners from a lower threshold (also proposed by the Henry Report); or
- reducing concessional and non-concessional contribution caps or levying a higher tax on earnings when contributions exceed a cap.

The last two options would constrain the flexibility of contribution arrangements that may pose problems for people with interrupted patterns of employment (particularly women). These options could be complemented by measures to encourage the use of superannuation savings for genuine income maintenance purposes during retirement, as discussed in the previous section.

The Committee also sees considerable merit in aligning the earnings rate between the accumulation and benefits stages, noting this might require other measures to promote appropriate minimum drawdowns and the direction of superannuation into retirement streams.

Options such as these ought to be considered as part of a broader review of retirement income policies. As discussed in Section 1, the significant interactions between the superannuation, pension and tax systems necessitate a systems-wide perspective with consideration of the broader implications. A broader review would enable holistic consideration of a broader set of levers to better address a number of factors:

- Level and distribution of tax concessions – There is a strong theoretical case for treating superannuation savings on a comprehensive consumption tax basis when the benefits are consumed but that is not a practical option for Australia today given the legacy of superannuation tax arrangements in place. Equally, however, the idea that superannuation should be taxed in the same way as other non-housing savings on a full marginal tax rate basis is inappropriate given the objective of facilitating the smoothing of lifetime incomes. An intermediate option could ensure a more equitable distribution within the context of the current level of tax concessions
- Targeting – Very large balances may currently be used for purposes other than retirement incomes, may attract tax advantages and may potentially also allow access to the age pension. Firmer requirement to direct superannuation savings towards genuine retirement purposes and/or limit tax advantages when balances exceed some cap may ensure better targeting.
- Simplification – The system has been subjected to frequent changes resulting in high system complexity. Rather than adding more requirements to an already complex system, the opportunity should be taken for a broader review to identify solutions that reduce, rather than add, to overall system complexity.
- Alignment – Holistic review of the retirement income system would enable a better alignment of the individual components with the overarching objectives of the system e.g. the operation of the means test might be reviewed to ensure it takes sufficient account of the increasing level of superannuation savings (and other assets) that could and/or should be used for retirement income purposes..
- Implications for the wide variations in personal circumstances – The system arrangements need to support adequate retirement incomes for people in different circumstances including those with interrupted work patterns. The evidence shows that women hold a disproportionate amount of the low account balances in the system reflecting extensive periods in non paid work. Similarly, there are wide variations in the way people can or choose to transition into retirement. A broader review could give consideration to the set of measures that might best address such variations in circumstances.

Recommendation 6: Issues to be considered as part of a broader review of the retirement income system - The consideration of measures to better target superannuation concessions ought to be considered as part of a broader review of retirement income policies (as suggested in Recommendation 3) that would enable holistic consideration of a broader set of levers to better address the following factors:

- Simplification - identifying solutions that reduce, rather than add, to overall system complexity.
- Alignment – of the individual components of the retirement income system with the overarching objectives of the system such as the operation of the means test and whether it takes sufficient account of other assets and any wider capacity for people to direct their superannuation savings into income stream products.
- Implications for the wide variations in personal circumstances - measures that might best address variations in circumstances including people with interrupted work patterns.

5. Efficiency in the Accumulation Phase

FSI Recommendation 10: Improve operational efficiency during accumulation.

Subject to the outcome of a review, a formal competitive process may be needed to allocate new default fund members to MySuper products. A formal competitive process would extend competitive pressures from the wholesale default fund market to the broader default fund market and improve after-fee returns. It would also reduce costs for funds and compliance costs for employers, who would no longer be required to select default funds for employees.

This recommendation should only be implemented subject to the outcome of a review of the superannuation system's efficiency and competitiveness. This caveat acknowledges it is too early to assess the effectiveness of the Stronger Super reforms, although the Inquiry has reservations about whether these reforms alone will significantly improve system efficiency and member outcomes.

The compulsory and concessional nature of superannuation creates a greater obligation on government to ensure that the superannuation industry operates efficiently. Given its importance, the Committee supports the proposal for a review of the efficiency of the industry by 2020 after the *MySuper* reforms have been bedded down and have had sufficient time to operate. The Committee makes the following comments to guide the review.

The Committee considers that such a review would need to investigate:

- Whether competitive pressures in the industry are sufficient to stimulate the drive to efficiency; and if not why not; and
- Whether some form of government intervention is called for; reform options would need to be evaluated on a benefit cost basis.

5.1 Competition and Efficiency

In seeking to determine whether inefficiency exists in the industry, it is important to identify the factors preventing competitive outcomes for the Australian industry with a view to seeking to address such factors at their source. The existence or otherwise of barriers to entry and market concentration are the traditional starting points for an examination of competitive pressures in an industry.

In the case of the superannuation industry, it is not clear whether the large number of superannuation funds (294 APRA regulated funds) indicates a high degree of competitive pressure or whether it is reflective of a highly comfortable industry enjoying rapid growth driven by mandated and tax assisted superannuation contributions and earnings growth. Many elements of the business of superannuation (including funds management and administration) are subject to significant scale economies (Cummings 2012). The continued existence of a high degree of market fragmentation in the industry may serve as an indicator of insufficient market pressure for consolidation. It is certainly the case that not for profit superannuation funds are shielded from the threat of takeover as a form of competitive pressure by virtue of their mutual status unlike smaller retail funds. It would be important for the review to investigate both product/service market competition and the existence of competition in the market for corporate control.

Another important area of investigation is the role of the member in serving as a competitive discipline in the industry. At the time of the Financial System Inquiry (1997), it was assumed that active choices by superannuation members would serve as a discipline driving competition and improving overall efficiencies in the superannuation system. Since that time, *MySuper* reforms have fundamentally overturned this assumption by reorienting the choice architecture to recognizing the role of the member as a largely disengaged decision maker. This reflected concern about the financial literacy of members to make complex decisions regarding the range of products offered and their level of interest (Adult Literacy and Life Skills Survey, 2006).

Research has identified various factors to explain why superannuation members have difficulties in making choices in relation to their superannuation.

- It is well established in the literature that there is low financial literacy among a large proportion of superannuation fund members (Bateman et al., 2012; Agnew et al., 2013). Financial products such as pension products are not readily understood without a high level of financial literacy.
- Errors in choices are often not recognized for a long time. Hence the superannuation market provides far fewer opportunities for consumer learning, while the risk and impact of wrong choices are significantly higher (Sy 2011).
- With over 200 public-offer funds and over 20,000 investment options and so many intermediaries involved in superannuation, information is either distorted or lost through multiple transmissions between the many service providers (Fear 2008).
- In numerous surveys, consumers have lamented the lack of accessible and comprehensive information. Institutional superannuation suffers from information asymmetry, where many members do not understand its products (Fear and Pace, 2008). Behavioral economics suggests that market competition is ineffective when investors are rationally bounded by complex choices (Bateman et al, 2014).

It would be useful for the proposed review to provide an updated assessment of the institutional and behavioral factors that make it very difficult for a large proportion of members to play an active role in the management of their own retirement savings. The proposed review ought to consider the extent to which these factors contribute to an absence of member engagement that serves to weaken competitive discipline on the superannuation industry, notwithstanding the existence of multiple service providers. This would include investigation of a number of sub-questions.

First, to what extent are superannuation members disengaged? The critical evidence that has previously been relied upon for disengagement among superannuation fund members is an observed low level of non-default decision-making. The Cooper Review (2009) acknowledged that defining and measuring engagement and interest in superannuation was difficult. Low levels of measured non-default member activity accompanied by evidence pointing toward disengagement led the Review to recommend the new 'choice architecture' and *MySuper.*

Analysis by Bateman et al, (2014) shows that the relationship between members' subjective evaluation of their own engagement and the non-default activities (that are commonly used to measure that engagement) is not straightforward. Therefore, assuming that a majority of members are uninterested (or disengaged) because they contribute into the default investment option may be incorrect. Further investigation of the extent of member engagement would be beneficial.

Second, if it is found that a certain proportion of superannuation funds members are highly disengaged, to what extent does this serve to cause a lack of competitive pressure on the broader market? Concomitantly, whether the 'engaged' members are sufficient to ensure competitive pressure on prices and outcomes? The consumers of all industries/products, certainly at a retail level, suffer from asymmetry in information and yet competitive pressure by the 'informed' usually protect the 'uninformed'. To what extent is information asymmetry more significant in the superannuation industry than other consumer service industries?

A study to try and resolve these issues would include consideration of:

- Whether the superannuation industry is able to segregate the market and provide similar services to different types of members at different prices.
- Whether the disengaged member can observe the price and service that the better informed, engaged member is receiving?
- The ease with which superannuation account balances may be transferred from one fund to another including all transition costs and risks.

The role of the self directed member (i.e. the self managed superannuation market) is highly relevant in this regard. The growth of this sector may be seen as a direct result of dissatisfaction with the institutional superannuation market.

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5.2 Options for reform

Based on the outcome of the above investigation, the inquiry should also examine whether some form of government intervention is called for. In doing so, alternative reform options, including a new superannuation member auction scheme as raised by the FSI and measures aimed at improving the fragmented structure of the industry, would need to be evaluated on a benefit cost basis.

The case for government intervention would then rest both on: evidence of the absence of competition leading to socially inefficient outcomes; and the efficiency gains from the proposed government reform more than outweighing the inevitable costs of such intervention.

Recommendation 7: Review of Superannuation Industry Fragmentation - That the FSI proposal review of the efficiency of the superannuation industry by 2020 (after the effects of the *MySuper* reforms have had a chance to work their way through the system) should investigate whether competitive pressures in the industry are sufficient to stimulate the drive to efficiency, and if not why not. Alternative reform options ought to be evaluated on a benefit cost basis including measures aimed at improving the fragmented structure of the industry.

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