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# **Choosing Not to Choose**

**Making superannuation work by default**

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The opinions presented and conclusions drawn in this paper, as well as any factual errors, remain the responsibility of its authors.

**Abbreviations**

ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ACTU	Australian Council of Trade Unions
AIRC	Australian Industrial Relations Commission
APRA	Australian Prudential Regulation Authority
ASFA	Association of Superannuation Funds of Australia
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
AWA	Australian Workplace Agreement
ERF	Eligible Rollover Fund
ESOMAR	European Society for Opinion and Marketing Research
FSR	Financial Services Reform
GDP	Gross Domestic Product
PJCCFS	Parliamentary Joint Committee on Corporations and Financial Services
NICRI	National Information Centre on Retirement Investments
OECD	Organisation for Economic Co-operation and Development
SG	Superannuation Guarantee
SMSF	Self-managed superannuation fund

## Summary

Since July 2005, the great majority of Australia's ten million workers have been able to choose their superannuation fund. When it was introduced, the Coalition Government represented the Choice of Fund policy as a major victory for consumers. In reality, the majority of Australians have derived little benefit from greater choice and competition in the superannuation sector. In fact, the recent changes have benefited some sections of the community—the financial services industry and highly engaged consumers—but have failed to adequately protect those who choose not to choose.

The fact that fewer than ten per cent of workers actively choose a fund should not come as a surprise. Indeed, as little as four per cent of workers switch super funds each year and around half of this is 'passive' choice due to job change or fund closure. Because participation is compulsory, a great many fund members, and particularly those a long way from retirement, do not take a keen interest in their super. Being automatically enrolled in a retirement savings system is not conducive to active consumer decision-making.

Choice of Fund has also been largely unsuccessful in lowering the number of multiple accounts, one of the most serious problems for superannuation policy-makers. In fact, the number of accounts per employee has actually increased, suggesting that choice has not 'empowered' consumers to take even the most basic action to improve their superannuation arrangements.

Three years on, the failure to promote consumer-centred competition has resulted in considerable waste across the super system. Average fees levied by fund managers have not fallen, remaining at around 1.25 per cent of funds under management (equating to around one per cent of GDP), and significant fee and performance variations persist between not-for-profit funds and for-profit (retail) funds. Moreover, it is estimated that Australians pay around \$2.4 billion a year in commissions on superannuation assets, including \$862 million on their compulsory superannuation contributions. Financial outcomes for workers can vary considerably depending on the fund that their employer nominates as the default fund.

In addition, many employers are frustrated with the increased administrative burden associated with Choice of Fund and uncertain about their responsibilities in nominating a default fund.

The key economic rationale for the Choice of Fund policy was to increase competition for the benefit of fund members. Unfortunately, low switching rates and an increase in multiple accounts raise serious doubts about the policy's effectiveness in stimulating competition.

Widespread disengagement on the part of many fund members means that consumer-driven competition in the super sector is deficient. Instead of competing to attract individual members, funds compete for the attention of intermediaries such as financial planners. This 'distribution-side' competition imposes additional costs on the super system and explains why Choice of Fund has not resulted in lower fees and better performance.

Choice of Fund is the most recent initiative in a long-term shift towards greater individual choice in a largely compulsory system, yet the principles of choice and compulsion sit uncomfortably together. Choice of Fund was based on the assumption that consumers are interested in and able to make sensible decisions about their retirement. Compulsion, on the other hand, assumes that most individuals need help to save adequately for retirement. What has been missing is a set of policy arrangements that promote the interests of disengaged consumers.

Default arrangements are a highly effective policy option because they can improve financial outcomes for those who decline to make an active choice while retaining flexibility for those who want it. In this paper, we outline a model of default arrangements that can benefit both active and passive consumers in the financial marketplace.

The power of well-designed default mechanisms is already reflected in the compulsory nature of the Superannuation Guarantee (SG). Workers are not required to ‘do anything’ in order to start building super savings; super moneys are deducted automatically from pay packets by employers in much the same way as income taxes. While the SG has resulted in dramatic increases in super coverage and account balances over the last 16 years, a more thoughtful use of default mechanisms has significant potential to result in even better outcomes for many Australians.

Default arrangements should be based on sound principles if they are to make financial markets work to the benefit of all participants, and especially ordinary workers. The following lessons have been drawn from the results of empirical research with the Australian public and from the findings of behavioural economics.

- While Australians value autonomy in relation to their financial affairs, many are frustrated with the complexity of the superannuation system. They would prefer simpler choices to be available. Default options are an effective way to protect consumers who struggle to make good financial choices in a complicated environment. *Default arrangements should therefore be simple and effective, while allowing participants to opt out if they prefer more choice or flexibility.*
- People are subject to a range of behavioural biases, which can negatively affect the decisions they make about retirement. *Default options should therefore embody a rational approach to retirement preparation in the interests of fund members without the need for costly financial advice.*
- People tend to make poor financial decisions in situations where benefits will be realised only in the distant future. *Default options in superannuation should therefore focus especially on the needs of people who are a long way from retirement, or whose accumulated benefits are relatively modest.*
- Despite their stated intentions, many people will not make the best choices about their super fund or their investment strategy. *Default options should therefore be structured to maximise asset accumulation by allocating investments appropriately and minimising fees.*



- Australians want the superannuation system to be fair to fund members and to society as a whole. *Default options should therefore maintain fairness in the way that assets are accumulated and invested.*
- People without financial expertise are susceptible to misleading messages in the area of retirement investments. *Default options should therefore be designed to reduce the likelihood that fund members will make decisions based on how choices are presented rather than on their inherent financial value.*

Sound defaults can be enacted in a variety of ways, including smarter regulation of superannuation funds and more thoughtful design of financial products. Some parts of the super system already have default arrangements in place, most notably via the industrial relations system, although there is ample room for improvement.

Many employers do not need to choose a default superannuation fund because their workers are employed under awards or agreements that nominate a specific default fund. In fact, such default arrangements apply to most employers and most employees and the new national industrial relations system will see the number of workers in this situation increase.

Those default funds specified in awards or industrial agreements often adhere already to many of the principles for good default arrangements. This may in part follow from the joint employer-employee trustee arrangements that apply to industry, not-for-profit and some corporate funds, which have historically outperformed retail funds.

Where a default fund is not specified through an industrial arrangement, employers have responsibility for nominating a super fund for those workers who decline to choose one. In many instances this is a difficult decision for an employer to make, and under current arrangements there are no universal mechanisms to ensure that the needs of employers and employees coincide.

Based on the principles for good default options, we propose that superannuation funds be required to meet certain standards before they can be nominated as an *eligible default fund* for workers who choose not to choose.

These standards would benefit employees by lowering fees and protecting savings, and would benefit employers by reducing the costs associated with administration and selecting an appropriate default fund. Once a list of eligible funds is in place, employers with responsibility for nominating a fund will be able to easily identify those funds capable of delivering good outcomes for their employees. This system would ensure that employees, who do not exercise choice and are not protected by an industrial agreement or award, would have a safety net in place to protect their superannuation savings from unnecessarily high fees, commissions and underperforming funds.

When a person changes jobs, the super system should enable them to automatically retain their fund as their default fund, unless they make an active choice to the contrary. This arrangement would preserve one of the important beneficial features of the present system—the ability to take a super fund from one job to the next.

We propose six criteria for eligible default funds, which together provide a ‘safety net’ for workers who choose not to choose.

1. *Cap ongoing fees and charges.* The maximum fee should be determined by an independent regulator.
2. *Prohibit entry and exit fees.* Such costs act as a major barrier to consumer choice and distort competition.
3. *Prohibit the payment of ongoing financial advice fees, including commissions.* If workers are placed in the default fund, by definition they have not made an active decision about their superannuation fund. It is therefore unlikely that they have received any formal financial advice and they should not have to pay for it.
4. *Offer employers a clearinghouse service.* Employees who exercise Choice of Fund currently place additional administrative costs on employers. A clearinghouse facility, which can process payments to multiple funds simultaneously, should be a standard element of the superannuation system.
5. *If contributions cease, keep members in the default fund.* To avoid the erosion of worker savings due to personal circumstances like illness, parenthood or job loss, members should not be transferred to a more expensive Eligible Rollover Fund or ‘personal plan’ without their explicit consent.
6. *Automatically follow up arrears in payments.* Although most employers meet their superannuation obligations, some shirk their responsibilities. Default funds should provide a mechanism to identify and respond to situations where full contributions have not been paid.

Most Australians have declined to exercise choice about their super fund and there is confusion and uncertainty in the community about exactly how super moneys are invested. Our research shows that many people would value the opportunity to use their superannuation to invest in socially purposive or desirable activities—that is, for ‘nation-building’. Policy-makers should therefore provide fund members with more opportunities to invest in such endeavours, and the ability to make simple choices about this. For their part, super funds should consider the ethical and environmental implications of their investments and better communicate these to members.

Maximising choice remains at the heart of superannuation policy in Australia. Yet choice is only beneficial where people want more flexibility and where they have clear notions of what they want. This is evidently not the case for many Australians. Governments therefore have a responsibility to examine how people really behave and to structure policy accordingly.

## 1. Australia's superannuation system

### 1.1 Introduction

On 1 July 2005, the former Coalition Government's Choice of Fund policy came into effect. For the first time, millions of Australian workers were given the option of nominating a fund for their compulsory superannuation contributions. At the time, the Government represented Choice of Fund as a major victory for consumers and competition. In reality, the majority of Australians have derived little benefit from greater choice and competition in the superannuation sector.

Choice of Fund is the most recent step in a long-term shift toward greater individual choice and flexibility within a largely compulsory superannuation system. Unfortunately, the facilitation of individual choice through the current structure does not assist those who choose not to choose. While it is quite easy for consumers to contribute to their super, it is very difficult for them to make the right decisions to get the most out of their accumulated savings.

This paper explains how well-designed default options, which look after people who choose not to choose, can improve the superannuation system to the benefit of many Australians. It draws on information from many sources, including relevant industry, academic and government reports, and objective data supplied by superannuation funds. It also reports on the results of new empirical research conducted by The Australia Institute and Industry Super Network.<sup>1</sup>

This chapter describes the origins of the current superannuation system and provides an overview of its key features. It also discusses community attitudes towards compulsory superannuation.

Chapter 2 explores how the ethos of freedom of choice and individual responsibility has become increasingly important in superannuation policy and how these interact with the compulsory foundations of the system.

Chapter 3 evaluates the impact of greater choice in superannuation using many different sources of evidence. It tests whether the Choice of Fund policy has delivered the benefits promised by its proponents.

In Chapter 4, some of the practical lessons of behavioural economics applicable to superannuation policy are revealed. These are used to build a framework for superannuation policy that relies on real-world evidence about consumer behaviour.

Chapter 5 applies this framework to the current superannuation system. It shows how specific default arrangements can deliver greater efficiency and effectiveness for super fund members.

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<sup>1</sup> A previous paper published by The Australia Institute, *Choice Overload: Australians Coping with Financial Decisions*, included survey and focus group findings relating to personal finances in general. This process yielded a great deal of information on community attitudes to superannuation, which are described in this paper where relevant. In addition, Industry Super Network commissioned several consumer attitudes surveys, yielding results that have also been included in this paper. Details of the research methodology for all of these studies can be found in Appendix A.

## 1.2 The origins and purpose of compulsory superannuation

Australia has a long history of innovation in retirement saving. The first private superannuation scheme in Australia was established by the Bank of New South Wales in 1862, more than a decade before the first pension scheme in the US was established (Borowski 2005). Tax exemptions or subsidies have applied to superannuation contributions since 1915 but until the 1970s, employer-based superannuation was largely limited to public servants, financial institutions and large manufacturing firms. In 1974, the first national superannuation survey found that only 32 per cent of the workforce had superannuation. These were primarily males working full-time, with only 15 per cent of females and 24 per cent of private-sector employees having membership of a superannuation fund at that time (ABS 1974).

In the 1970s and 1980s, policy concerns about the fiscal viability of supporting an ageing population became more pressing. Unlike some other developed countries such as the US, Australia did not have a national contributory social security scheme and the cost of the age pension and other welfare payments were funded on a 'pay as you go' basis from general taxation revenue. By the early 1980s, when governments and trade unions started to negotiate in earnest to expand access to employer-based superannuation, total superannuation coverage was around 45 per cent of the working population, with the age pension still taking the primary role in retirement provision (Borowski 2005). Following strong campaigning by the union movement, the Hawke Labor Government struck an agreement with the Australian Council of Trade Unions (ACTU) in 1987 to introduce superannuation into industrial awards on a gradual basis. This brought superannuation coverage to 51.3 per cent of the labour force by 1988 (ABS 1995). The Government described award-based superannuation as the cornerstone of 'a flexible and sustainable retirement income policy', which would deliver higher rates of savings and higher economic growth in the near term and improved retirement incomes in the long term (Howe 1989). It also enabled the Labor Government to deliver full indexed wage increases without contributing to inflationary pressures.

In 1992, the Keating Labor Government extended coverage to the majority of the workforce by introducing a system of mandatory employer superannuation contributions known as the Superannuation Guarantee (SG). As with award-based super, the SG was designed to address a number of policy problems: the growing burden on government expenditure of an ageing population; high inflation exacerbated by wages growth; and a shortfall in aggregate private savings. Defined benefit schemes, under which employees receive a predetermined income in retirement, were becoming increasingly unsustainable for large employers (including the public service) as life expectancy increased, the population aged and labour became more mobile. The SG signalled the decline of defined benefit funds in favour of defined contribution (or 'accumulation') funds (described in more detail in Chapter 2).

Under the SG, superannuation coverage quickly grew to 80.5 per cent of the workforce (ABS 1995). The rate of SG contributions required of employers rose gradually from three per cent of ordinary time earnings at its inception to nine per cent of wages in July 2002, as prescribed by the timetable in the original legislation. Although originally intended to reach 15 per cent, the SG was frozen by the Howard Government and remains at nine per cent. Introducing compulsion into the

superannuation system was a major milestone in retirement savings policy; it has been highly effective in overcoming natural consumer inertia in saving for retirement. Compulsion has been the key factor in the growth of the super system, as shown below.

Another important feature of Australia's super system is the significant tax concessions it offers. For example, employer contributions to superannuation accounts are taxed at just 15 per cent rather than at the individual's marginal tax rate. Earnings on moneys invested within the system are also taxed concessionally and, following the implementation of the former Coalition Government's 'Better Super' reforms in July 2006, withdrawals are tax-free for people over 60 years of age. So-called 'tax expenditures' on superannuation (i.e. tax subsidies compared to other kinds of income) were estimated at \$26.8 billion in 2007–08 (Treasury 2007).<sup>2</sup> Superannuation thus represents a considerable ongoing investment by the Commonwealth in the economic welfare of Australians in retirement.

### 1.3 The current superannuation system

#### *Types of funds*

There are various types of superannuation funds that a worker can join. The number of member accounts and the level of assets in each fund type are set out in Table 1.

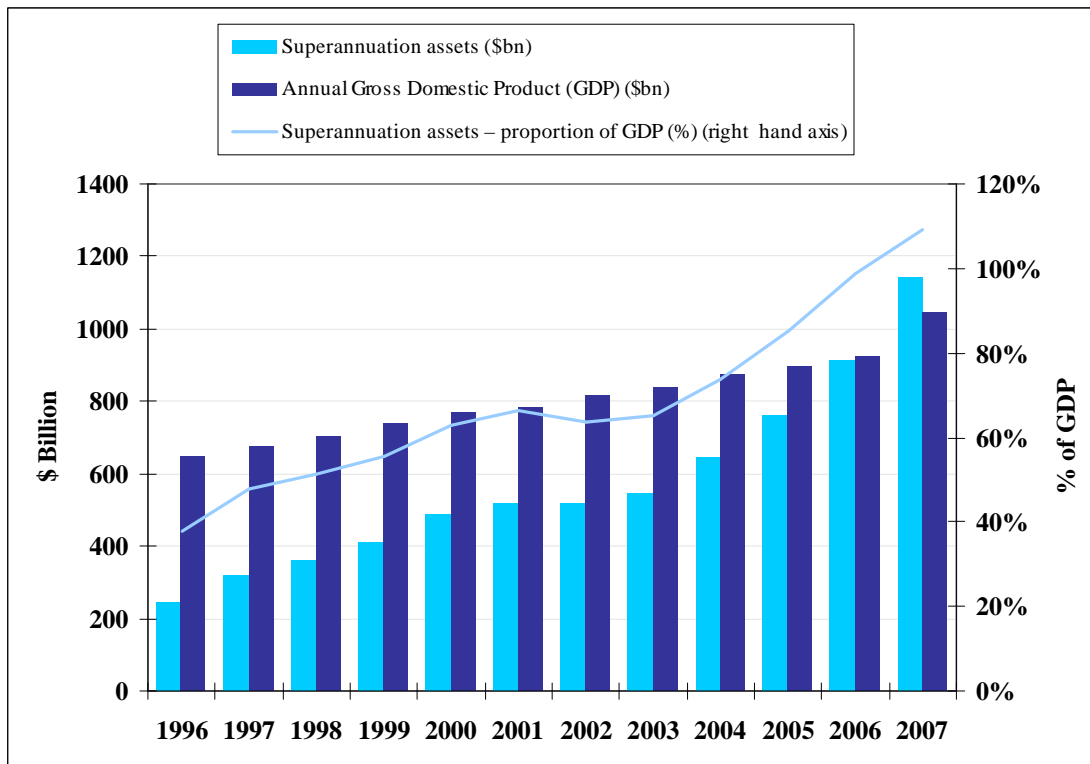
- *Retail funds* are run by commercial enterprises and are usually available to all workers. In June 2008, there were 166 retail funds (APRA 2008a).
- *Industry funds*, which are run on a non-profit basis, were originally set up for people working in particular industries and specified in industrial agreements. Since Choice of Fund was introduced, most industry funds have been opened up to members outside their original sector, although some remain open only to people in specific industries. There are 72 industry funds in total (APRA 2008a).
- *Public sector super funds* were established for government employees and are generally not open to other employees; there are 40 such funds (APRA 2008a).
- *Corporate funds* are usually set up by a single employer or group of employers and are not open to non-employees. There were 228 corporate funds in June 2008, but this number has been in decline since APRA introduced new licensing requirements (APRA 2008a).
- People can choose to set up their own fund, known as a *self-managed super fund* (SMSF), and have greater control over how their assets are invested. Administering a SMSF can be time-consuming and costly for low balance accounts; however, the control they afford members makes them an attractive option for many high net-worth individuals (NICRI 2008). There were 387,936 SMSFs in June 2008, an increase of 8.7 per cent on the previous year, equating to an average of around 2,500 SMSFs created every month (APRA 2008a).

<sup>2</sup> Given the extent of superannuation tax expenditures, the term *self-funded retiree* is highly misleading where retirement incomes are derived from superannuation.

## Assets

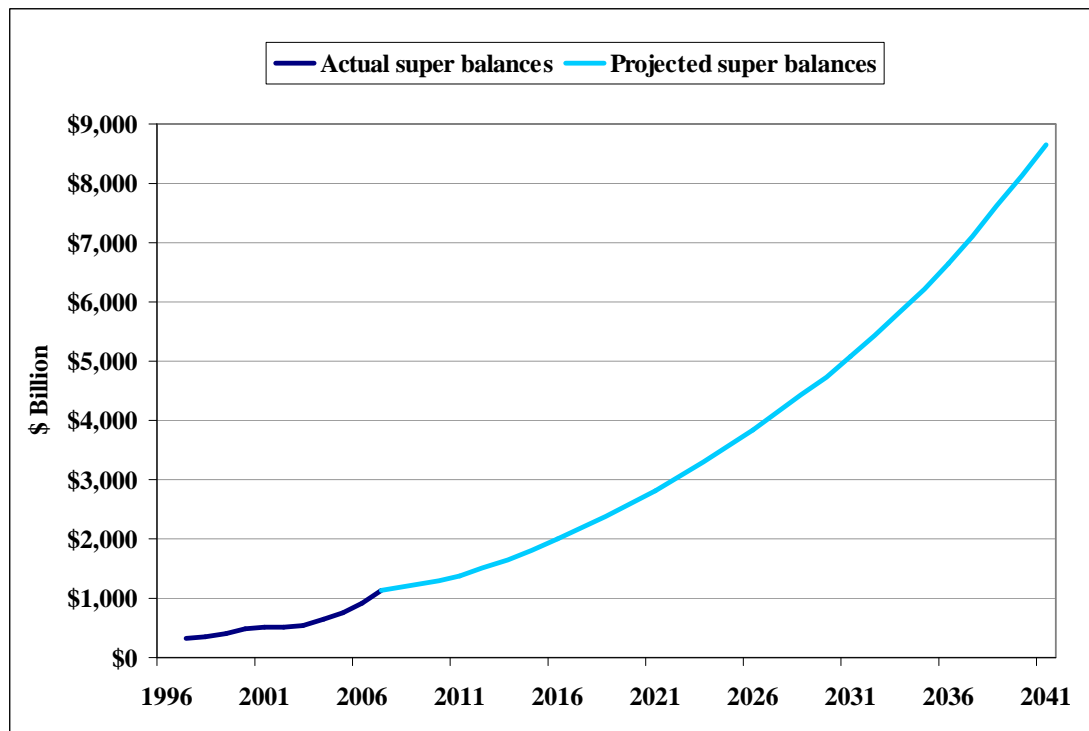
Superannuation is now the largest financial asset held by Australian households, with average super balances standing at \$35,520 for women and \$69,020 for men in 2006 (Clare 2008). As of March 2008, total assets held in Australian superannuation funds had grown to around \$1.1 trillion and covered almost 90 per cent of the workforce (APRA 2008a; Nielson 2008a). As Figure 1 shows, super assets have recently outstripped GDP. By 2041, super balances are projected to reach \$8.6 trillion in nominal terms (Rothman and Tellis 2008). Figure 2 shows the growth in superannuation assets since 1997 and the projected level of growth over coming decades.

**Figure 1 Superannuation assets as a proportion of GDP, 1996–2007**



Sources: ABS 2008a; APRA 2007; APRA 2008a.

**Figure 2 Growth in total super balances (actual and projected), 1996–2041**



Sources: APRA 2008b; Rothman and Tellis 2008.

### *Number of accounts*

As well as the significant growth in assets since the SG was introduced, there has been a remarkable growth in the number of member accounts. As Table 1 shows, there are more than 30 million superannuation accounts in existence, more than triple the number of people in the Australian workforce. Many of these accounts remain 'lost' and the consumer advocacy organisation CHOICE has estimated that fees on unnecessary superannuation accounts amount to between \$1.2 billion and \$2 billion per annum (CHOICE 2006). Figure 3 shows how the number of super accounts has grown since 1996. Chapter 3 discusses the issue of multiple accounts in more detail, and examines the impact of changes in super policy on the multiple accounts problem.

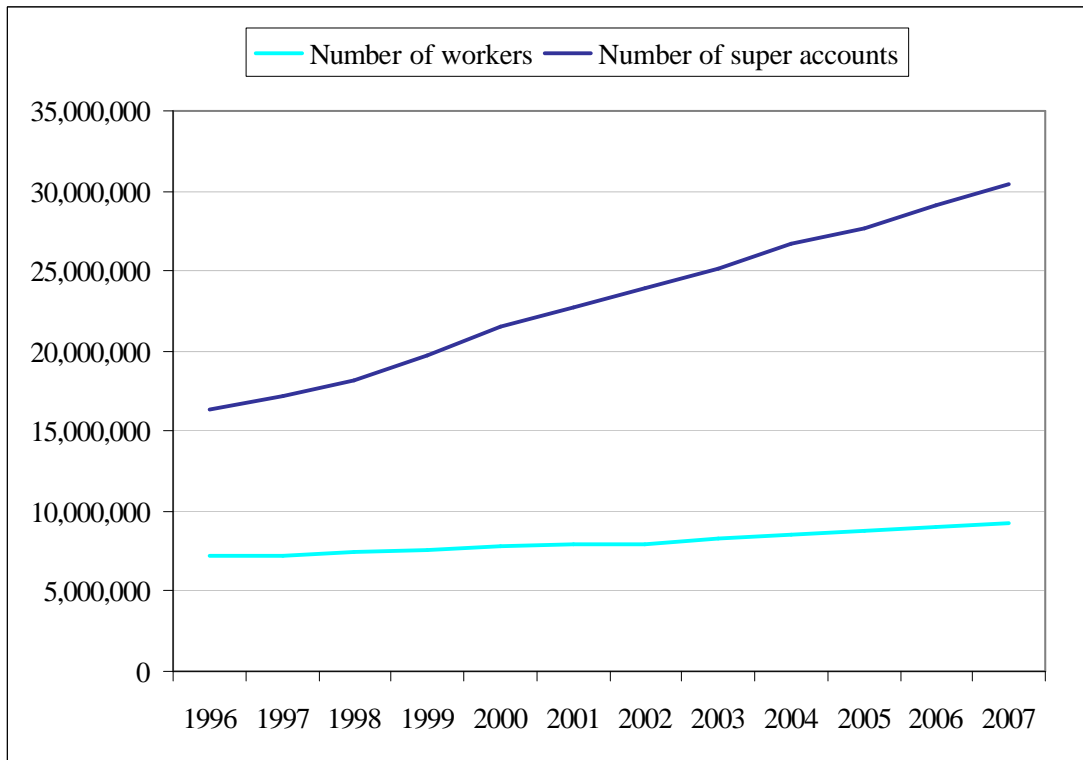
**Table 1 Superannuation accounts and assets, June 2007**

	Number of member accounts ('000)	% of member accounts	Assets (\$ billion)	% of assets
Corporate	676	2.2	69.2	6.8
Industry	10,654	35.1	197.3	19.4
Public sector	2,925	9.6	177.6	17.5
Retail	15,437	50.8	369.7	36.4
Small**	702	2.3	286.6	28.2
<b>Total</b>	<b>30,394</b>	<b>100</b>	<b>1,143.7*</b>	<b>100</b>

Source: APRA 2008c

\* Total assets include pooled superannuation trusts and balance of life office funds (not listed in table).

\*\* Small funds are defined as those with less than five members. The majority of these are self-managed super funds as defined by the *Superannuation Industry (Supervision) Act 1993*.

**Figure 3 Number of workers and super accounts, 1996–2007**

Source: APRA 2007; ABS 2008b

#### 1.4 Community attitudes to the SG

While Australia's compulsory superannuation system has been extensively reviewed by academics, policy-makers and international organisations (see for example OECD 2007), little work has been done to explore the attitudes of Australians towards the system as a whole. Since consumers are the ultimate beneficiaries of superannuation and are directly affected by most of the recent changes in superannuation policy, The



Australia Institute undertook some research into consumer attitudes to superannuation. The Institute gathered community views through a series of six focus groups and a survey of 1,002 adult Australians.<sup>3</sup> Focus group findings regarding general attitudes to superannuation are reported below, while additional findings on more specific issues are described elsewhere in this report where relevant.

### *Compulsion*

Focus group participants across all ages and at all levels of the income scale expressed strong support for the SG. The fact that superannuation is compulsory was regarded very positively, with most people agreeing that they would not have the self-discipline or foresight to plan properly for their retirement in a way that would ensure a minimum standard of living.

*I think compulsory super is a good policy, with the ageing population and people living to 80. Otherwise, people would just spend, spend, spend.*  
(30–49, Canberra, higher income)

Older participants recalled the government ‘campaigning’ in the 1980s to convince the population that the aged pension was a thing of the past, thereby arguing for the need for superannuation and self-reliance in retirement. ‘There won’t be a pension for you’ was said to be the message conveyed.

*The realisation that I needed to put more money into super wasn’t an age thing, it was from the government’s campaign and the awareness that it brought forward.* (50–70, Adelaide, higher income)

The message has been well and truly received with people of all ages believing that, at some point in the future, the age pension will be phased out, making superannuation the only source of retirement income for many people.<sup>4</sup>

*At some stage in the future there’ll be only one person working, turning the lights on and off. And he won’t be able to afford to pay for the pensioners.* (50–70, Adelaide, lower income)

*We’ve got to be self-reliant—otherwise we’re going to have to pay for all those baby boomers and their pensions.* (18–29, Sydney, higher income)

### *Replacing the age pension with super?*

While there was general support for the SG, there was also widespread agreement among focus group participants across all ages, incomes and genders that the age pension is an essential feature of the social security system in Australia and should remain so into the foreseeable future, despite any demographic challenges on the horizon. The idea of a ‘safety net’ was strongly supported, with most people conceding that misfortune or individual circumstances can mean that not everyone is

<sup>3</sup> Details on research methodology can be found in Appendix A.

<sup>4</sup> This is somewhat at odds with recent messages conveyed by the Rudd Government. For example, Superannuation Minister Nick Sherry stated in June 2008 that ‘Labor introduced the age pension that has endured for 100 years—and it will last for the next 100 years and beyond’ (Sherry 2008c).

able to accumulate enough wealth to fully fund their retirement and that the pension should enable recipients to maintain a decent (though modest) standard of living.

*Some people wouldn't be able to survive without the pension. (30–49, Wollongong, lower income)*

*You can live on the pension, but you have to go without things—like electricity! (50–70, Adelaide, higher income)*

*You always need a safety net. So the pension should be there for people who need it. (30–49, Canberra, higher income)*

Despite the perceived necessity of an income safety net in old age, it was generally agreed that government can no longer afford to extend the age pension to everyone in retirement and that individuals should support themselves financially if they are able. In fact, the idea of having to get by on the pension at its current level appeared to be an incentive for some people to save more for retirement.

*I don't want to live like my parents, who are on the pension. I see how they live and I don't want to live like that. (30–49, Wollongong, lower income)*

Now that individuals are largely expected to fund their own retirement, some older people (particularly those on higher incomes) argued that pensioner-only concessions should be extended to the general population of retired people. They pointed out that their generation (i.e. baby boomers) is stuck in the middle of two different approaches to retirement funding—one via public provision and one through private saving and investment over a lifetime. People over 50 regarded themselves as much more affected by this policy shift than later generations will be because they had not had the time to accumulate sufficient superannuation. Among people nearing retirement there was some resentment that they would not be able to reap the full benefits of superannuation, even while the age pension has become subject to a strict means test.

*People who are over 50 are going to be incredibly disappointed with their super. Yet the politicians tell you your future is bright because of employer-based super. (50–70, Adelaide, higher income)*

In reference to media coverage of the notion of raising the retirement age, some younger people expressed concerns that current policies encouraging people to work past retirement age might be extended to effectively force people to work even where health concerns or general fatigue mean it would not be in their best interests to do so.

*You can't send a 70-year old to work. (18–29, Parramatta, lower income)*

A small number of people who took part in this research had not benefited from compulsory super because they were self-employed for all or most of their working lives. These people were very worried about how they would support themselves in retirement since they had not been able to put away enough savings after they realised how ill-prepared they were. They felt let down by a system that protects employees but not those running a small business or those out of the workforce for significant periods of time.

*I won't be able to support myself. I've only ever had self-employed super. I'm hoping I can live on the pension. (50–70, Adelaide, higher income)*

*The need for strong super policy*

These focus group findings indicate that there is clear public support for both compulsory superannuation and a strong safety net through the age pension. However, additional findings (reported in Chapter 4) show that many Australians remain disengaged with their superannuation and that procrastination and inertia play a central role in consumer behaviour. It is therefore critical that the positive aspects of the current system (including compulsion and a safety net) are retained, while improvements are made through additional features that allow super fund members to make good decisions about their retirement savings.

## 2. Choice in superannuation

### 2.1 Increasing choice in a compulsory super system

At the time the SG was introduced there were few opportunities for members of employer-based superannuation schemes to exercise choice over the management and investment of their retirement savings. Most funds had limited investment options available, if any, and members were compelled to join either the fund chosen by their employer or set out in the relevant industrial agreement. Over time, the regulatory and policy framework has changed to promote greater choice and flexibility for fund members. The system as it currently stands incorporates several different models relevant to the responsibilities of super funds and the role of fund members. These are:

- the *Traditional Model*, whereby the trustee is compelled to act in the best interests of fund members, exercising their duties carefully, skilfully and solely to benefit members
- the *Investor Model*, where the member is a consumer or investor and individual choice and responsibility are emphasised
- the *Public Model*, whereby a super fund is considered to be a ‘quasi-public institution’ and super is used as a tool of public policy (Donald 2008).

Regulatory change has resulted in a gradual shift away from the traditional model, where risk and responsibility was borne primarily by those managing super moneys, towards the investor model, where choice is emphasised and risk and responsibility is increasingly borne by individual members. Sy characterises this shift as a move to a ‘market model’ where ‘the implicit assumption ... is that market discipline from competition will lead to cheaper products with better risk return characteristics that individuals can choose to suit their own circumstances’ (Sy 2008a). This shift is apparent in the rise of defined contribution funds, in the increasing number of investment options within funds, and in the implementation of Choice of Fund policy, all of which are described below. The ongoing challenge for superannuation policy-makers is to facilitate meaningful choice while retaining the protective and public policy imperatives of a universal super system. In other words, the desire to promote choice and flexibility must not undermine other essential elements such as a strong safety net and broad participation.

Choice of Fund is the most recent example of the shift in superannuation regulation and governance from the traditional to the investor model. An earlier shift occurred in the decline of *defined benefit* schemes in favour of *defined contribution* (or accumulation) schemes. Under defined benefit schemes, retirement benefits are calculated according to an individual’s salary prior to retirement rather than on the total value of member contributions and investment earnings. While defined benefit schemes often had poor vesting and preservation rules until legislation to tighten up the system was introduced alongside the SG, they did absorb the investment risk on behalf of members (Drew and Stanford 2003). Members who were in a position to benefit from defined benefit schemes did not need to worry about the impact of investment risk on their ability to fund their retirement.

The introduction of award-based superannuation, and later the SG, shifted the balance away from defined benefit schemes and towards defined contribution schemes where it is the member who bears the investment risk. In 1982–83, 82 per cent of fund members were covered by defined benefit funds but by 2005–06, 97 per cent of fund members were in either accumulation (i.e. defined contribution) funds or funds that had a mix of accumulation and defined benefits (APRA 2007).

The transfer of risk and responsibility from trustees and plan sponsors to fund members was further accelerated by the introduction of member choice of investment strategy during the 1990s. Investment choice allows members to choose from a range of investment types in major asset classes (e.g. Australian shares, international shares, property or fixed interest), combinations of asset classes (e.g. ‘growth’, ‘balanced’ or ‘stable’) and other options (sometimes including individual shares listed on the Australian Stock Exchange). The trend towards increasing member investment choice reflected overseas developments and was based on the traditional economic assumption that well-informed economic agents act rationally to maximise their self-interest. It embodies the belief that ‘investment choice enables plan members to select their optimal investment portfolio that matches their risk and return preferences and ultimately, maximises retirement incomes’ (Gallery *et al.* 2004, p. 45). The number of funds offering investment choice to their members has increased steadily over time, with 80.1 per cent of funds with greater than \$100 million in assets offering member investment choice as at June 2006 (APRA 2007). Modern retail funds have around 97 investment choices, by far the highest average number. By contrast, most industry funds offer an average of ten investment options per fund while public sector funds and corporate funds have an average of eight and six investment choices per fund respectively (APRA 2007).

Despite now being offered such extensive choice in investment strategy, the majority of fund members still do not elect to choose an investment option. They are therefore placed in their fund’s default investment strategy, which is determined by the fund’s trustee and is usually the ‘balanced’ option. At June 2007, 46.3 per cent of all fund assets were in the default strategy; people who exercise choice of investment strategy tend to be wealthy individuals with large superannuation balances (PJCCFS 2007). The high proportion of individuals who fail to make an investment choice highlights the need to pay close attention to default options for SG contributions, even where members ostensibly have extensive choice. With this in mind, the Parliamentary Joint Committee on Corporations and Financial Services (PJCCFS) noted in August 2007 that ‘default investment options remain a critical component of the compulsory superannuation system’ (PJCCFS 2007, p. 56).

## **2.2 The Choice of Fund policy**

The Choice of Fund policy is the most recent regulatory change designed to increase the choice and flexibility available to super fund members. Prior to 2005, most employees were unable to choose their superannuation fund; instead, funds were nominated in industrial awards and collective agreements or employers chose a fund on their workers’ behalf. Some employers did allow employees to choose a super fund, although this was not the norm; the number of workers in this situation prior to Choice of Fund has been estimated at 1.9 million, or 20 per cent of the workforce (Clare 2006). A further one million people (or 11 per cent of the workforce) already had choice of fund by virtue of being self-employed or business owner-managers

(Clare 2006). People who chose to participate in voluntary superannuation schemes were, of course, free to choose their own fund as in the past.

The Coalition Government attempted to pass Choice of Fund legislation on three occasions, the first two being defeated in the Senate in 1997 and 1998. The final policy was implemented through the *Superannuation Legislation Amendment (Choice of Superannuation Fund) Act 2004* (Cth). Choice of Fund applied from July 2005 for federal awards and July 2006 for state awards, and meant an extra 4.8 million more workers were able to choose their fund (PJCCFS 2007; ATO 2005). This brought the proportion of people able to choose their superannuation fund to at least 80 per cent of the workforce.<sup>5</sup> Excluding self-managed super funds and those open only to certain kinds of employees (such as corporate funds and public sector funds), the number of funds from which the average working Australian can choose is now well over 200 (APRA 2008b).

For workers who do not exercise choice, employers are obliged to nominate a fund into which contributions are paid. This is often a difficult decision for an employer to make and under current arrangements there are no universal mechanisms to ensure that the needs of employers and employees coincide.

Many employers do not need to choose a default superannuation fund because their workers are employed under awards or agreements, which nominate a specific default fund. In fact, this situation applies to most employees and most employers. Because both employers and employees are involved in the industrial negotiation process, default funds that are identified in awards and agreements are often well-chosen, meeting the needs of both employers and workers. Indeed, default funds named in awards have historically outperformed retail master trusts.

For those employers who are not bound to contribute to a specific default fund by virtue of an award or other industrial arrangement, the requirements governing their selection of a default fund are minimal. The chosen fund needs to comply with the *Superannuation Industry (Supervision) Act 1993* (Cth) and, from July 2008, it needs to offer a minimum level of life insurance (with some exceptions). Trustees of regulated funds are prohibited from offering inducements to employers to select their fund as the employer-nominated default fund or from otherwise encouraging employees to join their fund.

### **2.3 The case for choice in superannuation**

From a philosophical perspective, the key principle behind the Choice of Fund policy and the choice of investment within funds is that individuals should be able to exercise control over their own money, which in the case of superannuation is preserved and invested on their behalf, on a compulsory basis until retirement age. In the words of the PJCCFS, choice ‘gives employees greater control over their

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<sup>5</sup> While Choice of Fund now covers most of the workforce, certain types of employees are exempt. These workers are generally employed under certain workplace agreements, including Australian Workplace Agreements (AWAs), although choice can also be exercised under some AWAs. Employees in certain types of defined benefit fund and those who have reached a certain level of benefit in a defined benefit fund, are also excluded from Choice of Fund, along with some federal and state public sector employees (PJCCFS 2007, p. 16–7).

superannuation savings [and] a greater sense of ownership of these savings' (PJCCFS 2007, p. 17).

From an economic perspective, Choice of Fund was intended to encourage competition and efficiency among superannuation fund managers. The proponents of the policy predicted that greater competition would result in lower fees and charges, higher returns and better service when consumers could switch funds. As the Explanatory Memorandum to the Choice of Fund legislation put it: 'This measure is expected to increase competition, efficiency and performance within the superannuation industry and result in reductions in fees and charges for persons with superannuation' (ATO 2005). Echoing the Coalition Government, the financial sector argues that choice enables fund members 'to better manage their investment approach and therefore minimise exposure to risk. It also enables members to move away from more conservative investment options that might provide low long-term average returns ... Under member investment choice fund members bear the investment risk' (PJCCFS 2007, p. 55).

The then Federal Labor Opposition challenged the Choice of Fund legislation on the basis that it did not adequately address significant disclosure issues, did not regulate fees and charges, and did not provide for a 'comprehensive and effective consumer education campaign' (Gallery *et al.* 2004, p. 49). Despite this, Labor has acknowledged the importance of choice and competition in superannuation (Sherry 2008a). Even the chief 'architect' of the modern superannuation system, Paul Keating, has argued for greater choice: 'When I talk about choice, I am talking about getting fee structure down and returns up' (quoted in Coates and Vidler 2004, p. 12). Maximising choice remains an article of faith in Australian superannuation policy.

As shown in a previous paper from The Australia Institute, the notion of consumer choice is at the heart of mainstream economic thought (Fear 2008). From a psychological perspective, choice has been shown to enhance people's sense of self-determination and motivation (Botti and Iyengar 2006). Unfortunately, there are other situations where more choice can actually undermine wellbeing and result in confusion and anxiety. This is particularly the case in the financial realm where many people lack fixed preferences and do not understand the difference between one product and another. As financial decisions (and financial products) continue to become more complex, the benefits associated with greater choice diminish.

#### **2.4 Initial estimates of the uptake of choice**

Initial estimates of the proportion of members who would switch funds if given the choice differed widely. Predicted switching rates varied from eight per cent to 47 per cent, with a number of estimates in the 15 to 17 per cent range. Much of this variability was due to differences in the way survey questions were asked as well as the way respondents' stated intentions were interpreted (Clare 2006).

Prior to the introduction of Choice of Fund, job changes and fund closures resulted in around seven or eight per cent of workers switching funds in a given year. It is important to separate this 'base rate' or 'passive' switching (related to job change and fund closure) from 'active' switching (prompted by Choice of Fund) (Clare 2006). In one of the more measured predictions, The Association of Superannuation Funds of Australia (ASFA) estimated that 'less than ten per cent', and possibly around six per

cent, of fund members would switch as a direct result of Choice of Fund on an annual basis. When those people who switch due to employment changes or fund closures were included, this figure was projected to be around 11 or 12 per cent (Clare 2006).

In the following chapter, we compare these initial estimates to the actual rates of switching observed since the Choice of Fund policy came into effect. In addition, we consider how well Choice of Fund has met its original objectives and describe some of the unintended consequences of the policy since its introduction.



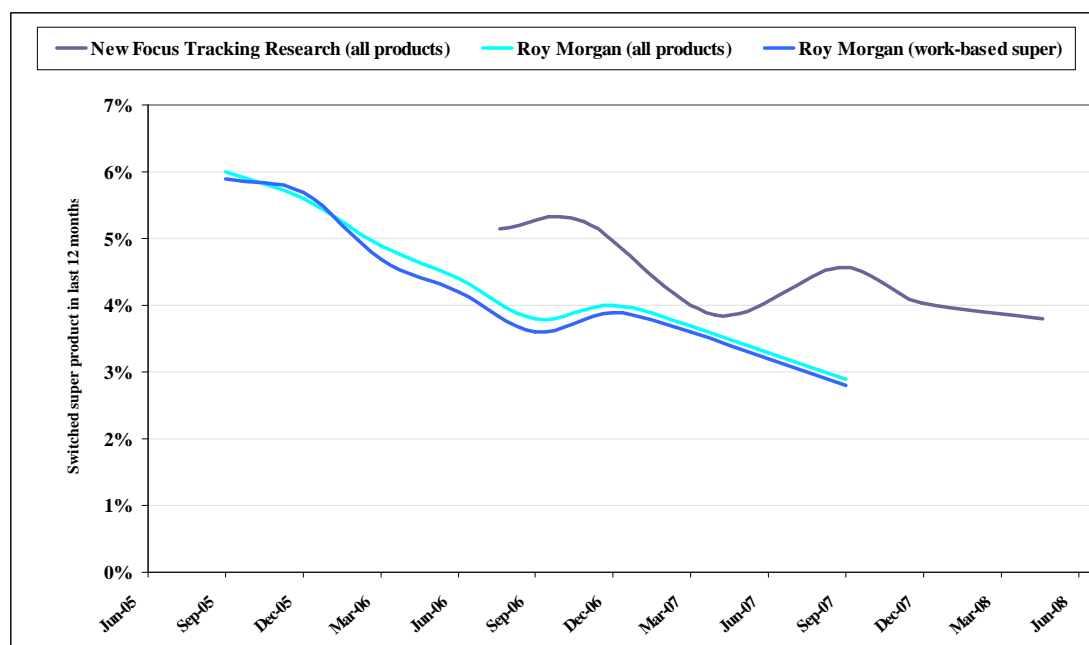
### 3. Choice in superannuation—the results

This chapter describes the available evidence on the outcomes of extensive choice in superannuation. It shows that the purported competitive benefits of Choice of Fund have failed to materialise based on a range of indicators: the rate at which members have been exercising choice; the growth in multiple accounts; the level of fees and commissions that fund members are currently paying; and the growing complexity of the super system. The final section of the chapter asks whether a new definition of competition is required to ensure that consumers derive real benefits from the huge variety of fund managers in the marketplace.

#### 3.1 Switching rates

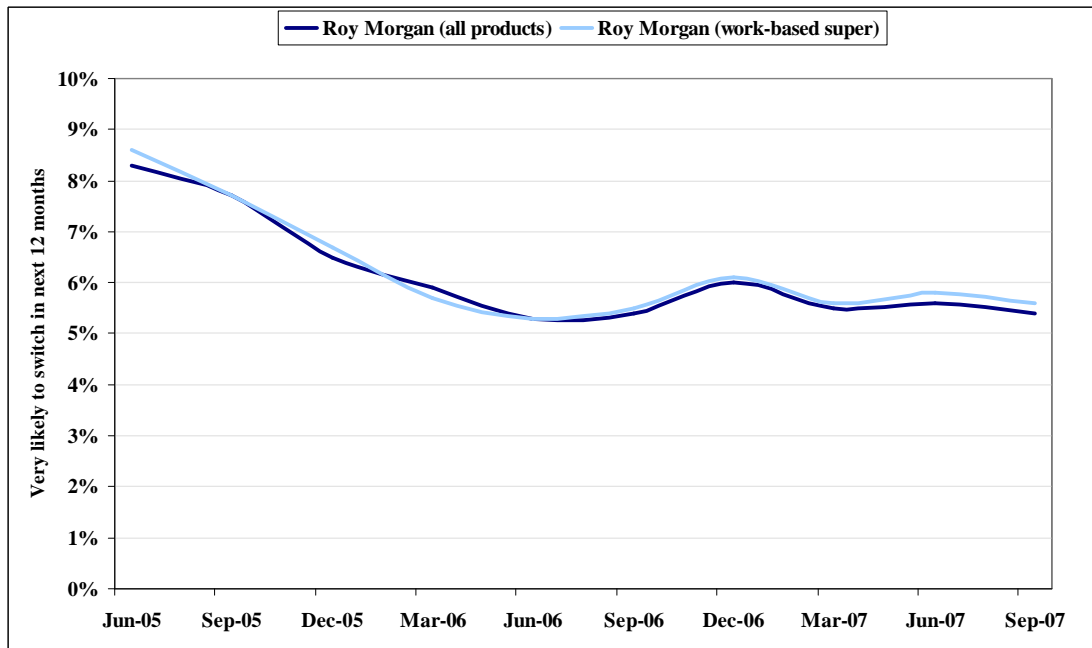
The number of members switching funds since July 2005 (when Choice of Fund began operation) has been considerably fewer than predicted. Figure 4 (below) compares the switching rates that have been reported through several data sources.<sup>6</sup> Because selecting a fund for compulsory contributions does not necessarily involve rolling over any existing super balances, the incidence of member switching has been mapped through surveys rather than through fund flows. The data clearly indicate a very low and declining level of consumer switching activity overall; switching activity peaked immediately following the introduction of Choice of Fund and has been declining ever since. The initial spike was arguably driven by an extensive consumer awareness campaign launched by the government to promote the change, a campaign that has since been discontinued. As Figure 5 shows, the proportion of members intending to switch funds in the future also continues to decline over time.

**Figure 4 Superannuation switching rates, June 2005–June 2008**



Source: Roy Morgan 2006a, 2006b, 2007a, 2007b, 2008; New Focus tracking survey commissioned by Industry Super Network

<sup>6</sup> The data sources compared include survey data from Roy Morgan Research (2006a, 2006b, 2007a, 2007b, 2008) and New Focus tracking data commissioned by Industry Super Network (see Appendix A for further details of the methodology utilised by New Focus).

**Figure 5 Proportion very likely to switch super funds, June 2005–Sep 2007**

Source: Roy Morgan 2006a, 2006b, 2007a, 2007b, 2008

Roy Morgan and New Focus Research (New Focus) survey data reveal that between 40 and 53 per cent of those who have switched funds did so *only because they changed employer or because their employer changed their nominated default fund*. In other words, a considerable proportion of switching (as many as one in two) is actually ‘passive’ rather than ‘active’, occurring when an employee changes jobs and does not nominate an alternative to their employer’s default fund. Overall, just ten per cent of Australian workers have taken the opportunity to choose their fund, according to Ernst & Young (2008, p. 13). Given that the key economic rationale for the Choice of Fund policy was to increase competition by encouraging consumers to make active fund choices, the seemingly low rates of active switching raise serious doubts about the policy’s effectiveness in delivering beneficial competition.

Despite recent trends indicating low (and declining) switching rates, some industry participants have suggested that rates of fund choice will increase in the future. CitiStreet (2008), for example, predicts that over the next five years the number of members actively exercising choice will increase from 3.5 to 7.5 per cent. It argues that such growth will come as a result of growing awareness and engagement on the part of super fund members, greater workforce mobility, employment growth in smaller companies and a higher proportion of mature-aged workers. However, results to date suggest that such predictions are again very optimistic. Most Australians remain disengaged with their super, and younger Australians (the most mobile segment of the workforce and therefore those with most need to choose a super fund), are especially indifferent. It also remains to be seen whether recent policy initiatives designed to encourage older people to remain in the workforce will have any significant effect on choice of fund.

Deloitte (2008) also questions whether the rates of switching seen so far are too low, suggesting that even rates of three to five per cent represent large sums of money as well as a significant proportion of job changers exercising Choice of Fund (Deloitte

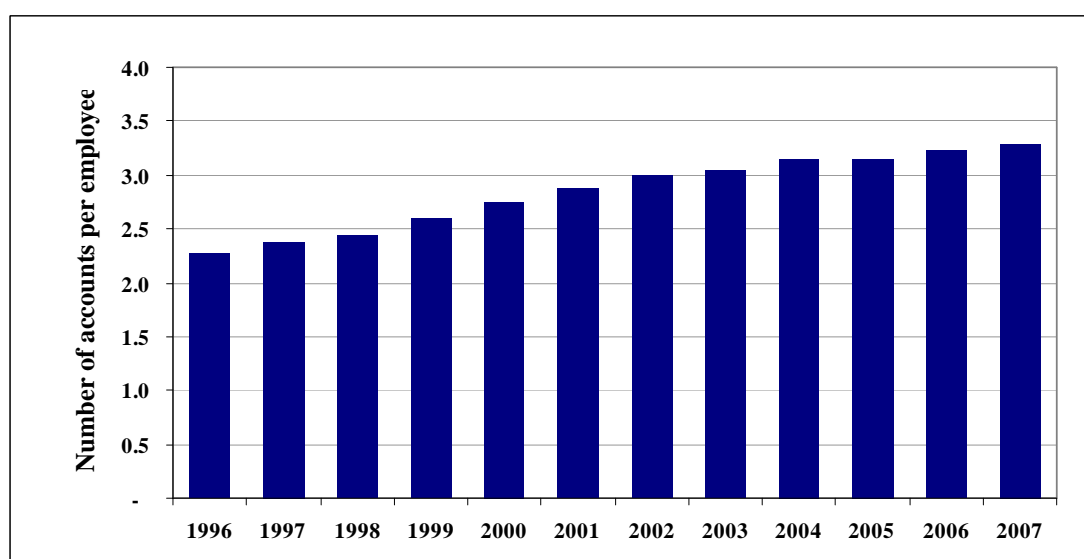
2008). Nevertheless, the original aim of the Choice of Fund policy was to encourage *all* consumers to make active decisions about their super, not just the small proportion of workers who change jobs every year. The Deloitte report also implies that members who exercise choice of fund automatically roll over their existing balances into their new fund. However, as the next section explains, this is often not the case, particularly for members who switch funds passively from one employer default fund to another.

### 3.2 Multiple and lost accounts

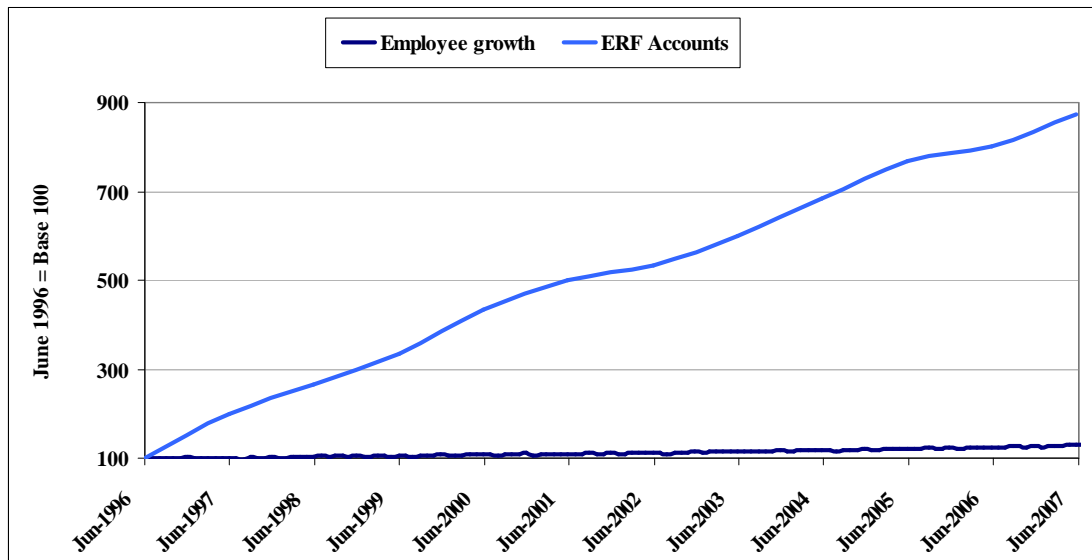
In addition to these more direct measures of consumer switching behaviour, the growth in member accounts, and in particular the growth in lost accounts, provides a further indication of whether consumers are making the most of the extensive choice now available to them. Enabling workers to take their super account from one job to another was a major benefit of Choice of Fund; it was expected to reduce the number of multiple and lost accounts. If the policy was working as intended, declining switching rates could actually be an indication of *improved* consumer engagement with super, showing that workers were using choice to consolidate their multiple accounts into their preferred fund, which they could then take from one job to the next. If they are not consolidating their accounts, however, fund members will continue to bear a heavier cost burden in the form of unnecessary account keeping and administration fees.

The available evidence indicates that Choice of Fund has been largely unsuccessful in lowering the number of multiple accounts, meaning that the level of active consumer switching is in fact very low. As Figure 6 shows, the number of accounts per employee has actually *increased* from 3.15 at the introduction of Choice of Fund to 3.29 in 2007 (APRA 2007). The trust deeds of most super funds contain provision for rolling over the benefits of inactive, uncontactable or lost members into an Eligible Rollover Fund (ERF). As Figure 7 shows, the number of ERF accounts has also continued to increase since Choice of Fund was introduced, again outstripping labour force growth.

**Figure 6 Number of super accounts per employee, 1996–2007**



Source: APRA 2007; ABS 2008b

**Figure 7 Growth in lost accounts, 1996–2007**

Source: APRA 2007; ABS 2008b

Certain industry commentators have suggested that there are legitimate reasons to hold more than one super fund, for example to maintain beneficial insurance provisions (Clare 2007). While this may be the case for some individuals, insurance benefits alone would not explain the sheer number of accounts in existence, including ‘lost’ accounts. Deloitte (2008) has also argued that ‘many Australians may be consciously “diversifying” their superannuation’. Given the choice available to most fund members to diversify both their asset allocation and their choice of fund managers within the one super fund, it is highly doubtful that diversification across multiple funds yields any additional benefit, especially when the extra administration costs are taken into account.

There are, in fact, more compelling reasons than ‘conscious diversification’ preventing consumers from consolidating their super accounts. Consumer inertia and bewilderment at the complexity of the super system are central factors in the multiple accounts phenomenon. According to CHOICE (2006, p. 11), the barriers to account consolidation include ‘onerous administrative and identification requirements ... poor communication by funds and inadequate assistance to fund members ... the absence of an industry wide protocol on consolidation, inadequate consumer education ... exit fees, difficulties obtaining simple financial advice, and problems consolidating legacy products’. Many of these barriers apply equally to the process of switching funds, and have continued to apply since the introduction of Choice of Fund. The issue of exit fees is discussed at more length below.

### 3.3 Fees, commissions and returns

Trends in the fees charged by superannuation funds also indicate that Choice of Fund has not delivered the competitive benefits predicted by its proponents. With more than a trillion dollars in superannuation assets, the ongoing management fees levied by funds amount to substantial sums. In the year to June 2006 (the latest figures available), superannuation funds charged approximately \$10.5 billion in fees and expenses, or 1.26 per cent of funds under management, roughly equivalent to one per cent of Australia’s annual GDP (Rice Warner Actuaries 2007). The Minister for

Superannuation, Nick Sherry, has expressed concern about fees on superannuation assets, saying that ‘in a mature system that is 20 years old, we need to get the fees and charges down below an average of 1.25. So frankly, anyone who is paying much in excess of one and a quarter per cent needs to have a long hard look at the value of the fund to make sure that they're getting value for money’ (Sherry, 2008b).

At the time Choice of Fund was introduced, fees and expenses as a proportion of assets were already beginning to decline due to consolidation within the industry and the growing level of funds under management. Average fees dropped from 1.37 per cent of assets in 2002 to 1.30 per cent by 2004 and 1.26 per cent after the first year of Choice of Fund (to June 2006) (Rice Warner Actuaries 2007). Despite the decline in average fees, there remains a persistent divergence in fees charged by for-profit and not-for-profit super funds. Fee levels range from just 0.7 per cent of assets per annum for not-for-profit public sector funds to 2.12 per cent for personal superannuation funds (i.e. for-profit retail funds) (Rice Warner Actuaries 2007).

Since 2006, management fees have actually increased. Analysis by Chant West found that among the top 14 retail funds, average management costs rose from 1.67 per cent in June 2006 to 1.69 per cent by March 2008. Over the same period, average management costs for the top eight industry funds rose from 0.75 per cent to 0.83 per cent while costs for the top five public sector funds fluctuated, rising overall from 0.60 per cent to 0.62 per cent (with both these sectors remaining well below retail funds in cost terms) (Chant West 2008). These figures suggest that Choice of Fund has not generated the significant reduction in fees that was predicted to occur as a result of increased competition.<sup>7</sup>

**Table 2 Average management costs, June 2005–March 2008\***

	June 2005	June 2006	June 2007	March 2008
Retail master trusts	1.71	1.67	1.68	1.69
Industry funds	0.71	0.75	0.80	0.83
Public sector funds	-	0.60	0.59	0.62

Source: Chant West 2008

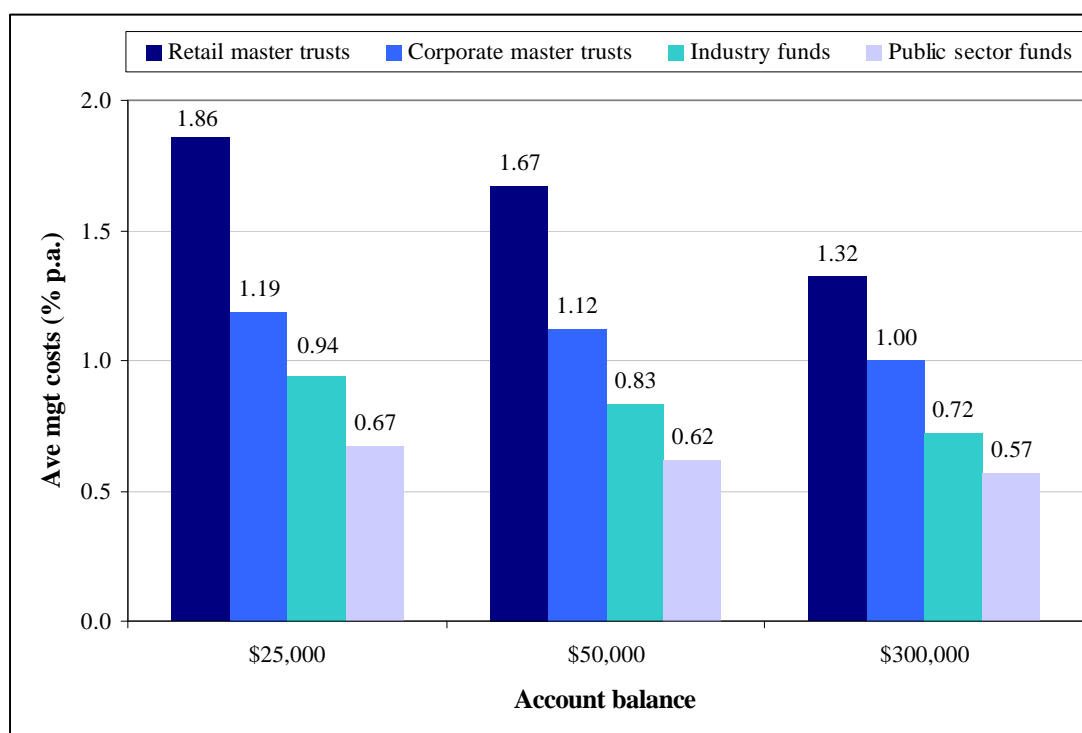
\*Average management costs apply to the 14 leading retail master trusts (according to assets under management and net inflows), the eight industry funds with assets over \$7 billion, and the five largest public sector funds.

Recently released research from Rainmaker Information shows fees increasing after the introduction of Choice of Fund but declining slightly in 2008. In 2004–05, Rainmaker calculated the average fee for workplace funds at 1.30 per cent, increasing

<sup>7</sup> Various factors influence the management fees that superannuation fund members incur. According to Rice Warner Actuaries (2007, p. 3), the drivers for fee *reductions* have included ‘increased average account balances and strong market performance; the decline in legacy products (which generally have higher fees), a number of mergers ... resulting in greater economies of scale; the large number of corporate funds that have outsourced; and reduced fees offered by ... providers in competitive tenders to win new business from the outsourcing funds’. Meanwhile, the factors influencing fee *increases* include ‘one-off costs incurred by trustees in preparing for and obtaining licences from APRA; cost of compliance; higher advertising and marketing expenses as a result of Choice of Fund; and higher investment fees due to performance-related charges by fund managers’.

to 1.44 per cent in 2007 before falling back to 1.41 per cent in 2008 (Sampson 2008). Despite differences in the exact figures, it is clear from all these data sources that there has not been a widespread downward movement in management fees, and significant fee differentials between different segments of the superannuation sector remain. Although these differences are apparent in fees levied on accounts of various balances, people with lower account balances such as women, young people and people on lower incomes tend to pay higher fees as a proportion of their assets (see Figure 8, below).

**Figure 8 Average management costs for different account balances**



Source: Chant West 2008, p. 2.

In addition to ‘standard’ fees for management and advice, many super funds charge substantial exit fees. Exit fees by their very nature inhibit people from making an active choice about their super fund because they increase the immediate financial costs of switching or consolidating funds. According to CHOICE (2006), exit fees are often much higher than is necessary to cover the administration costs associated with fund transfer. It argues that ‘to the extent that exit fees are set at a level designed to promote account retention then they are anti-competitive’ (CHOICE 2006, pp. 13-4).

Higher fees in some segments of the market would not necessarily be a problem for fund members if those fees were more than offset by higher returns. Yet returns data show that the most expensive segments of the market (i.e. for-profit retail funds) on average deliver the lowest returns. According to Sy (2008a): ‘In recent years, it has become increasingly evident ... that retail funds earn about 2% a year less than other institutional funds on average over a ten year period’. Returns data from SuperRatings indicate that over one, three and five years to 30 June 2008, not one master trust (i.e. for-profit retail fund) was in the top 20 performing balanced funds. An examination of seven-year returns shows that only one retail fund made the top 20 list (SuperRatings 2008). In other words, huge portions of the super industry remain simultaneously

uncompetitive on both fees and returns. The fact that such significant performance and fee variations persist, despite the liberalisation of the super sector, shows that the Choice of Fund policy is having little positive impact on the very factors that can most strongly affect accumulated retirement savings.

### 3.4 Complexity and choice

A previous study by The Australia Institute, *Choice Overload*, documented how Australians are coping with the increasingly complex decisions they need to make about their financial affairs. It found that people are often presented with choices that they would prefer not to make, or prefer someone else to make on their behalf. The study also showed that inadequate levels of financial literacy prevent many people from making sensible and informed financial choices (Fear 2008). The Consumer and Financial Literacy Taskforce (2004, p. 2) has acknowledged the bewilderment that many people feel about their financial affairs:

Consumers have become confused and fatigued by the plethora of information sent to them from many different sources. Not only is it a problem of processing and understanding information but also of knowing what information to trust.

This applies in many areas of financial decision-making, including savings, credit cards, mortgages, private health insurance and even mobile phone contracts. It is especially the case for people making decisions about financial investments such as superannuation. Under Choice of Fund, workers can now choose from more than 200 superannuation funds, some with more than 100 investment options. While some people may value this degree of choice, other people are likely to be bewildered. As Borowski (2005, p. 50) has commented, 'Australia's retirement income system ... has become a marvel of complication requiring considerable expertise to understand and negotiate it'.

However, the Choice of Fund policy did not engender such complexity by itself. Instead, it built on an already complicated regulatory structure, which has developed over two decades of incremental change. Constant changes mean that many people are unsure what the present arrangements are and make little effort to find out because they anticipate further changes. A study by ASIC in 2004 found that 'complexity and frequent changes in eligibility rules for social security and taxation treatments on super meant that retirees either ignored these issues, or simply asked their adviser for guidance on the best option for them to take' (ASIC 2004, p. 6). Meanwhile, 65 per cent of respondents to a survey by ANOP Research Services were not confident that the changes to the super system in the 2006 budget were here to stay (Cameron and Gibbs 2006).

Focus group participants of all ages and at different ends of the income spectrum expressed concerns about the constant changes to the superannuation regime. Not only were such changes said to be difficult to keep up with, they were also said to 'shift the goalposts' so that people planning for retirement in the long term could not be sure what the right financial decisions might be given the prospect of future alterations to the superannuation system.

*It's hard to keep up with the constant changes to super. It could change on the day you retire and impact on your savings. (30–49, Canberra, higher income)*

*I put away a lot of money in super because that's what I should do. But I don't know that the decisions I make today will be applicable tomorrow. It may be a tax benefit to put it away this year, but not necessarily next year. (30–49, Canberra, higher income)*

*You don't know what things are going to be like in the future. So if you're putting away a certain amount now, you just don't know what you're really going to need. (30–49, Canberra, higher income)*

In July 2006, when the latest round of changes to superannuation reduced (or 'streamlined') tax on large superannuation contributions and benefits, there was official recognition of the intricacy of the taxation arrangements, which 'are complicated and limit individual choice' (Treasury 2006). However, there was no mention of the complexity of decision-making in the post-choice environment, nor of how this can result in disengagement and confusion on the part of many Australians. When the 2006 changes were explained in the ATO's awareness campaign, the original 'Simpler Super' policy had been renamed 'Better Super', presumably because the changes resulted in a system that is anything but simple (Treasury 2006).

Contributing to the confusion that many people feel is the language commonly used by financial specialists. Superannuation has its own jargon (e.g. *trustee, sole purpose test, preservation age*), along with a separate tax regime. According to a recent *Ipsos Mackay Report*, 'Australians of all ages find the language of superannuation confusing and often irrelevant. They are often suspicious of super funds because of the complexities of the information provided by them' (Ipsos 2008, p. 9). Recent reforms to the financial sector designed to simplify matters by improving disclosure have actually resulted in a more confusing state of affairs because of the lengthy product disclosure documents, which financial providers now commonly provide to customers.

Focus group participants were ambivalent about the greater degree of choice they could now exercise over their superannuation. Many people expressed a desire to compare fees and charges, although only a small number had actually taken action to do so.

*I started looking around. Then I lost the information. Then it just got too hard. (18–29, Sydney, higher income)*

Although most people remained with their original or default fund, there was widespread agreement that Choice of Fund is a good policy in principle because, they felt, it would encourage greater competition and thereby lower fees. Younger people in particular favoured more choice in a general sense but were less enthusiastic about greater choice in the context of superannuation and other financial products.

All groups were asked whether it was preferable to have the range of choices in super funds and investment portfolios limited to a manageable number, or whether more choice was always better in the super context. Most people said they preferred a



limited choice, generally nominating between three and ten options; more than ten was said to be excessive and confusing. Even the younger groups favoured limiting choice to some degree and limited choice also appeared to be more popular among the lower-income groups.

These findings indicate that Australians generally support the notion of increased choice and competition, believing that it will bring benefits to them. However, they are frustrated with the complexity of financial decisions and find it difficult to make meaningful choices about their superannuation. In fact, many people would prefer that their super options were limited to a manageable level. For these reasons, additional well-designed default options, which would allow people to make better choices about their super, are likely to appeal to the Australian public.

### 3.5 Financial advice

Faced with the enormous complexity of the superannuation system, many people end up seeking professional advice. According to the results of a Newspoll Market Research (Newspoll) survey recently commissioned by Industry Super Network,<sup>8</sup> 42 per cent of people over 18 had consulted a financial planner or adviser in the previous three years and 29 per cent within the previous 12 months. Worryingly, around one in six people who paid for advice (17 per cent) did not know how much they paid. In addition, only 22 per cent actually negotiated the fee they paid for the advice.

A major component of the costs to super fund members is in the form of adviser commissions.<sup>9</sup> A recent report by Rainmaker Information (2008a) estimated that total commission payments from the superannuation industry for the 2007 calendar year were \$2.4 billion. Of this, \$862 million (or more than a third) were commissions on SG assets, with the remainder being commissions on non-SG moneys (such as voluntary superannuation contributions). Trailing commissions (i.e. ongoing payments calculated as a percentage of assets managed) accounted for \$1.8 billion, including 76 per cent of all commissions on SG assets (Rainmaker Information 2008a). Given that a large proportion of fund members do not make active decisions about their super, there are serious doubts as to whether \$2.4 billion worth of 'value' was derived from the financial advice that members paid for in that year. Instead, it is more likely that advisers and adviser networks are deriving considerable profit from unwitting consumers who remain unaware of the commissions built into their personal superannuation arrangements.

Sales commissions from retail super funds mean that many financial advisers have an incentive to recommend particular products whether or not they are in the best interests of clients. A 2007 Rainmaker Information study found that not one of the top 30 financial planning groups had included an industry fund on their 'approved product' lists (i.e. the set of funds they were authorised to recommend to clients) (Rainmaker Information 2007). In a market where consumers are passive, product issuers (commonly retail super funds) compete to gain control of distribution networks via incentives such as commissions rather than competing through their offerings to fund members. This has resulted in widespread community scepticism

<sup>8</sup> See Appendix A for methodological details.

<sup>9</sup> In 2005–06, the 'cost of advice' (either built into overall management fees or charged to fund members through commissions or a fee for service) was 0.21 per cent of total assets, or around 17 per cent of all fees and expenses (Rice Warner Actuaries 2007).

about the independence and underlying motivations of financial advisers, as Industry Super Network survey results attest.

- Just 16 per cent of respondents believed that financial planners and advisers ‘give advice only with the best interests of their clients in mind’. By comparison, 47 per cent believed that they ‘give advice taking into account both their clients’ interests as well as the commission they will make’, while a further 22 per cent said that they ‘give advice only influenced by the commission they will make’.
- Eighty-four per cent of respondents agreed that ‘a law should be put in place which requires a financial planner or adviser to provide advice or make investments only in the best interests of their clients’.
- Seventy-eight per cent of respondents agreed that ‘commissions compromise the advice [planners] provide’.

Consumer concerns about financial advisers are supported by the results of ‘shadow shopping’ undertaken by ASIC in 2006, which set out to determine whether advice specifically relating to superannuation was lawful, adequate and helpful. ASIC found that 16 per cent of advice provided was ‘not reasonable, given the client’s needs’. Where consumers were asked to switch superannuation funds, one-third of the advice given ‘lacked credible reasons and risked leaving the consumer worse off’. Most worryingly, unreasonable advice was at least three times more likely where the adviser had ‘an actual conflict of interest over remuneration or recommending associated products’ (ASIC 2006, p. 2).

An earlier joint study by ASIC and the Australian Consumers’ Association on the quality of financial advice found that 17 per cent of financial plans were ‘poor’ or ‘very poor’. Only 21 per cent of financial plans were ‘good’ or ‘very good’, while 53 per cent were ‘OK’ or ‘borderline’. This research also showed that the overall quality of advice ‘was significantly worse if the planner was only paid by commission’ (ASIC 2003, pp. 4–6).

Many consumers have difficulty distinguishing good advice from bad advice. Another ASIC report, *Consumer decision making at retirement*, identified problems with how advice (whether professional or otherwise) is interpreted. Participants in this research ‘experienced significant difficulty in assigning weight to the various (at times conflicting) sources of advice they received ... Most had difficulty determining when they had received sufficient advice to make a decision, but looked for convergence of opinion’ (ASIC 2004, p. 8).

Despite these various concerns about the quality of advice and people’s capacity to interpret it properly, the financial planning industry has boomed since the introduction of compulsory superannuation. More than 16,000 licensed planners now operate in Australia, advising on almost \$400 billion worth of assets, and the planning sector continues to grow strongly (Rainmaker Information 2007). As the range of options in superannuation grows and decisions consequently become more difficult, the role of financial advice will expand accordingly.

### 3.6 The limitations of supply-side competition

The fundamental premise underlying liberalisation policies such as Choice of Fund is that market-based competition helps consumers by promoting efficiency among suppliers and driving down prices. A competitive and open market on the supply side is considered necessary to prevent firms from gaining too much market power, thereby securing efficiency gains for consumers such as lower prices and better products. This focus on ‘structural soundness’ is reflected in the types of measures typically used to assess competition: number of suppliers, market share and market contestability.

From a supply-side perspective, the market for managing compulsory superannuation assets in Australia is quite competitive. As we have already seen, workers are able to choose from more than 200 superannuation funds and can even take on the responsibilities of fund management themselves by establishing a SMSF. Within funds, members commonly have dozens or even hundreds of investment strategies to select from so that a vast range of investment ‘tastes’ can be accommodated. As Table 3 (below) shows, no single super fund has excessive market share based on funds under management. Taken together, the top 20 super funds account for 41 per cent of the funds under management and no single fund has a market share greater than five per cent. This is in stark contrast to other financial services sectors, such as the market for bank deposits, where (as shown in Table 4, below) the top 20 banks account for 95 per cent of bank deposits, with the big four banks alone accounting for nearly 63 per cent of the market.

What supply-side assessments of competition fail to capture is that, regardless of the number of suppliers, the benefits of a competitive market will not eventuate unless consumers make active choices that they know to be in their own best interests. If consumers do not ‘vote with their feet’ to reward suppliers who offer products that are superior in price, quality or innovation compared to other products in the market, there is little incentive for producers to compete on these features.

Research on the economics of ‘switching’ between suppliers has shown that informed decisions are necessary for competition in a given market to result in genuine consumer benefits. If too few consumers switch between providers, there is not enough competition on price and quality; if too many consumers switch, the transaction costs associated with customers ‘churning’ between products forces costs up, resulting in no net benefits for consumers. A body of research has emerged (primarily from Europe) examining demand-side features such as switching behaviour in order to assess the level of competition in markets like energy, telecommunications and insurance (Wilson and Waddams Price 2007; Giulietti *et al.* 2005; Pomp *et al.* 2005). This research shows that strong consumer agency on the demand side of markets is just as important for achieving efficient market outcomes as having no impediments to competition on the supply side.

**Table 3 Top 20 superannuation funds by assets under management**

Fund name	FUM (\$m)	Rank	Share	Segment
State Super (NSW)	37.9	1	4.6%	Government fund
AustralianSuper	30.2	2	3.6%	Industry fund
QSuper	26.4	3	3.2%	Government fund
UniSuper	24.3	4	2.9%	Industry fund
AMP Flexible Lifetime Super	22.5	5	2.7%	Master trust
MLC MasterKey Superannuation	20.7	6	2.5%	Master trust
Australian Reward Investment Alliance	19.4	7	2.3%	Government fund
Emergency Services and State Super	19.3	8	2.3%	Government fund
First State Superannuation Scheme	16.1	9	1.9%	Industry fund
Retail Employees Superannuation Trust	14.7	10	1.8%	Industry fund
HESTA Super Fund	14.0	11	1.7%	Industry fund
Sunsuper	13.3	12	1.6%	Industry fund
Construction and Building Unions Superannuation	13.1	13	1.6%	Industry fund
Telstra Superannuation Scheme	11.5	14	1.4%	Corporate fund
Mercer Super Trust (Corporate Super Division)	10.8	15	1.3%	Master trust
Colonial First State FirstChoice Personal Super	10.4	16	1.3%	Master trust
Government Employees Superannuation Fund	9.4	17	1.1%	Government fund
Plum Superannuation Fund Employer Division	9.2	18	1.1%	Master trust
Health Super Fund	8.0	19	1.0%	Industry fund
MLC MasterKey Business Super	7.4	20	0.9%	Master trust

Source: Rainmaker Information 2008b

**Table 4 Australian deposits in individual banks, June 2008**

	Total deposits* (\$m)	Share of total deposits
Commonwealth Bank of Australia	207,337	18.76%
National Australia Bank Limited	171,291	15.50%
Westpac Banking Corporation	163,775	14.82%
Australia and New Zealand Banking Group Limited	152,901	13.83%
St. George Bank Limited	76,471	6.92%
Suncorp-Metway Limited	37,779	3.42%
Bank of Western Australia Ltd	36,117	3.27%
ING Bank (Australia) Limited	29,250	2.65%
Macquarie Bank Limited	23,986	2.17%
BNP Paribas	18,448	1.67%
Bank of Scotland plc	17,913	1.62%
Bank of Queensland Limited	16,355	1.48%
The Royal Bank of Scotland plc	16,084	1.45%
Bendigo and Adelaide Bank Limited	15,403	1.39%
Adelaide Bank Limited	14,490	1.31%
HSBC Bank Australia Limited	12,388	1.12%
Société Generale	10,343	0.94%
Deutsche Bank Aktiengesellschaft	8,664	0.78%
Citibank, N.A.	8,428	0.76%
Co-Operative Central Raiffeisen-Boerenleenbank	7,389	0.67%
Other banks	60,645	5.49%
<b>Total</b>	<b>1,105,456</b>	<b>100%</b>

Source: APRA 2008c

\* Total deposits equal the sum of transaction deposit accounts, non-transaction deposit accounts and certificates of deposit, but exclude intra-group deposits.

According to the OECD, active consumers encourage firms ‘to innovate, improve quality and increase price competition’ (OECD 2007, p. 8). In addition, government regulators are often of the view that ‘for many products, vigorous competition is the single best protection for consumers’ (Office of Fair Trading 2008). The Productivity Commission’s recent report into Australia’s Consumer Policy Framework confirmed that ‘competition is a means to achieving an improvement in consumer wellbeing rather than an end in itself’ (Productivity Commission 2008, p. 28). Active consumer decision-making is therefore fundamental if a market liberalisation policy, such as Choice of Fund, is to be effective. A consumer-centric approach is particularly important in markets where demand-side market failure is more likely, such as where products are complex or purchased infrequently, or where there is a long lag between the purchasing decision and the time when the benefits can be assessed. By these measures, superannuation is arguably the quintessential product.

Data on member switching rates and the growth in multiple accounts since the introduction of Choice of Fund (reviewed above) suggest that superannuation fund members are, by and large, not making active choices and therefore not exerting the right kind of competitive pressures on super funds. Switching rates have been much lower than expected and a high proportion of those switching appear to be doing so only because they changed jobs and have adopted their new employer’s default fund. In addition, the number of multiple and lost super accounts continues to rise, suggesting that many employees are not transferring their balance when they join a new fund. The overall lack of movement on the part of super fund members suggests that funds are unlikely to feel pressure from consumers to compete on factors such as price and performance. This is borne out by the persistently large variation in fees charged by super funds, as well as the rise in management fees overall.

Consumer market theory argues that where too few consumers switch between products, alternative forms of competition generally develop, principally around marketing, distribution, and product differentiation. This supply-driven competition appears now to dominate the super industry, with funds competing to capture distribution networks in the form of financial planners rather than the patronage of individual employees. Greater differentiation also results in higher average costs for consumers as fund managers build in the costs of more sophisticated offerings. Although it was promised that workers would ultimately benefit from greater choice in superannuation, in reality it is the financial sector and some wealthy individuals who have gained the most.

### **3.7 Impact on employers**

As already explained, of the small number of consumers who switch funds, many do so when they change jobs and, in most instances, they join their new employer’s default fund. In practice, employee Choice of Fund could be better characterised as employer choice.

There is strong evidence that employers are dissatisfied with the extra administrative burden that they now bear under Choice of Fund. Survey research commissioned by Industry Super Network in late 2007<sup>10</sup> showed that once employer-nominated fund arrangements are in place, employers are very unlikely to revisit them; 94 per cent of

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<sup>10</sup> Details of the New Focus survey methodology can be found in Appendix A.

employers reported that it was unlikely or very unlikely that they would change their nominated fund in the 12 months following the survey. The main reasons cited by respondents for not seeking to change funds were that: no problems had been experienced or there was otherwise no need to change; changing was too much work and it was easier to stay in the present fund; and the current fund provided good services and was efficient or professional. Importantly, most of these reasons related to the *administrative concerns* of the employer and not to whether the current employer-nominated fund delivered *good outcomes for employees*.

These results are supported by a study undertaken by the Cameron Research Group (2007), based on interviews with 400 medium-sized businesses around Australia. This research found that superannuation decision-makers in business are increasingly 'of the view that if employees don't like the fund, it is up to them to change' (Cameron Research Group 2007, p. 19). Where a default fund is not named in an award or industrial agreement, the responsibility placed on employers to select a competitive default fund and to review that decision periodically imposes considerable costs. It also demands of employers a level of financial sophistication that some (especially small businesses) do not possess. Further, it encourages a reliance on outside advisers, many of whom have an incentive to recommend particular retail funds (see Section 3.6, below).

This study also showed that the costs of managing employee super are increasing and, as a result, many employers are approaching the employer-nominated fund as a 'set and forget' decision. According to this research:

- Fifty-four per cent of medium-sized businesses agreed that it is a 'hassle' when employees exercise their right to choose a fund;
- Eighty per cent of medium-sized businesses contribute to more than five funds;
- Only 54 per cent of medium-sized businesses review the performance and service of their nominated super fund; and
- The vast majority of medium-sized businesses with a superannuation adviser have no idea how that adviser is paid.

According to the Cameron Research Group, 'it is still the business—and not employees—that determine which default super arrangements that business will have' (Cameron Research Group 2007, p 19).

Other studies show that the Choice of Fund policy has increased the administrative burden on business. Superannuation administrator, CitiStreet, released a report indicating that processing Choice of Fund contributions is significantly more expensive than processing contributions to employer-nominated default funds. In fact, the cost incurred in processing Choice of Fund contributions is 50 per cent greater than the average cost, relative to total contributions made (CitiStreet 2008). A survey recently conducted by superannuation clearinghouse SuperChoice and The Association for Payroll Specialists showed that 'close to 60 per cent of medium to large-sized businesses find their choice-of-fund processes cumbersome and unsatisfactory' (SuperChoice and The Association for Payroll Specialists 2008).

Employers responding to this survey highlighted the disproportionate amount of time required to process Choice of Fund contributions, the different requirements and procedures of multiple funds, and low levels of employee understanding about super.

The current regime also imposes considerable search costs on those employers who must choose a default fund because their staff are not employed under industrial arrangements where specific default funds are nominated. Unfortunately, this creates an incentive for advisers and fund managers to artificially simplify employer decisions regarding the selection of employer-nominated funds. A system, which grants discretion to employers to choose the fund into which workers are automatically enrolled (unless they make an active choice), has the potential to create large conflicts of interest between employers, employees, super funds and financial planners. So long as employer and employee interests remain unaligned in this way, employers who are tasked with choosing a default fund (and are often the target of marketing efforts by funds and advisers) may end up not selecting the most appropriate default fund for their employees but may, instead, decide on a fund which presents a lower administrative burden.

### **3.8 Has choice in superannuation worked?**

Many Australians remain highly apathetic about their superannuation, exercising neither their right to choose a super fund nor their option to choose an investment mix. Instead, most people opt for the status quo by remaining with their current fund, which is often nominated by their employer. Where people do choose their fund, around three to six per cent per year (see Section 3.1), this is mostly due to job change or fund closure; ‘active’ choice on an employee’s part is actually as low as two to four per cent per year. Although Choice of Fund enables workers to take their super fund from one job to the next, most people do not take advantage of this opportunity.

Choice of Fund has also been largely unsuccessful in lowering the number of multiple accounts. In fact, the number of accounts per employee has actually increased, suggesting that choice has not ‘empowered’ consumers to take even the most basic action to improve their superannuation arrangements.

Widespread consumer disengagement helps to explain why competitive forces have not led to lower fees and better performance in the superannuation industry. Focus group findings suggest that, for the most part, consumers are not actively searching for the best deal, meaning that funds with low fees and good returns are not automatically gaining market share over their competitors. Instead, competition is structured around intermediaries like financial advisers, many of whom have little incentive to act in the financial best interests of ordinary fund members. The sheer complexity of the superannuation system continues to discourage people from taking an active interest in their super, a situation that has only been compounded through increased choice. With many people needing guidance on their retirement investments, the financial planning industry is thriving.

As a result, the competitive potential of Choice of Fund has not been realised. Fees levied by fund managers have not fallen since the introduction of Choice of Fund, remaining at around 1.25 per cent of funds under management; this equates to more than \$10 billion per year, or around one per cent of GDP. As well, Australians are paying around \$2.4 billion a year in commissions on superannuation assets, including

\$862 million on compulsory superannuation contributions. Of most concern is the fact that many Australians remain unaware of the fees and commissions they pay through their super.

Many employers remain frustrated with the increased administrative burden associated with Choice of Fund. There is also uncertainty about employers' duty of care in selecting an appropriate default fund for workers who do not choose a fund. Even where employers act in good faith, there is little guidance on how to make good decisions on behalf of their workers.

Together, these outcomes indicate that the anticipated benefits of choice in superannuation have not occurred. As Chapter 4 will argue, it is human nature to find long-term financial decisions difficult and there is a strong case for a system of default options, which will allow ordinary workers to choose not to choose yet still obtain maximum benefit from their retirement savings.



## 4. The case for good default options in superannuation

The effectiveness of the SG lies in the fact that workers are not required to ‘do anything’ in order to start building super savings; super moneys are deducted automatically from pay packets by employers in much the same way as income taxes. While the SG has resulted in dramatic increases in super coverage and account balances over the last 16 years, it has not encouraged consumers to make active decisions about their retirement savings. There has consequently been insufficient competitive pressure on funds to deliver good outcomes for their members. This chapter presents evidence that well-designed default options in superannuation would be of benefit to many Australians. It reviews relevant literature in the area of behavioural economics and psychology and presents findings from survey and focus group research conducted by The Australia Institute.<sup>11</sup>

### 4.1 Lessons for super policy from behavioural economics

Orthodox economic theory relies on the assumption that consumers are rational, utility-maximising agents who are able to find and understand all relevant information in order to make a decision (Muth 1961). In the last few decades, the field of behavioural economics has developed an alternative perspective, describing and quantifying how ‘non-rational’ modes of consumer decision-making can affect economic outcomes. The notion of ‘bounded rationality’ was popularised by Herbert Simon, who received the Nobel Prize in economics in 1978. Behavioural economics has become particularly influential since another two of its leading practitioners, Daniel Kahneman and Amos Tversky, were awarded the Nobel Prize in economics in 2002 for the development of ‘prospect theory’, which describes how people tend to value economic losses more keenly than economic gains. A related body of work, known as behavioural finance, has sought to show how the non-rational decisions of investors, traders and others can influence financial markets. In what follows, some of the more important lessons of behavioural economics applicable to superannuation policy are explained. Survey and focus group findings are also discussed where relevant.

#### *Choice overload and complexity*

Whereas policy-makers and economists emphasise the benefits of consumer choice, there is considerable evidence that too much choice can be detrimental to consumer welfare. Where there is no clear preference for one option over another, or where the costs of information are high, people often decline to make a choice or prefer others to choose on their behalf (Schwartz 2000; Iyengar and Lepper 2000). As a previous paper by The Australia Institute showed, ‘choice overload’ is particularly common in personal finances, with an estimated four in ten adult Australians believing there is too much choice in their financial affairs (Fear 2008).<sup>12</sup>

Behavioural economists have shown that extensive choice in work-based retirement schemes can lead to unfavourable rates of participation. Iyengar *et al.* (2003) have examined the effects of greater and lesser choice on the uptake of opt-in retirement savings accounts in US workplaces, known as 401(k) plans. They found that

<sup>11</sup> Details on the focus group and survey methodology can be found in Appendix A.

<sup>12</sup> Forty-two per cent of respondents agreed that ‘when I need to make a financial decision, I often find there is too much choice’ (Fear 2008, p. v).

participation in 401(k) plans is noticeably higher where fewer options are presented to employees. As the researchers conclude, providing them with too many options ‘may actually intimidate rather than induce employees to invest in personal retirement plans’ (Iyengar *et al.* 2003, p. 11). With the average number of investment choices available to Australian retail super fund members approaching 100, there is considerable potential for choice in superannuation to become overwhelming. In fact, abundant choice is why many people seek professional advice when making critical financial decisions. Constant changes to the superannuation system (discussed in Chapter 3) have further inhibited people’s ability to make informed decisions affecting their retirement. Almost half (44 per cent) of survey respondents agreed that ‘superannuation is too complicated to understand properly’, while only 26 per cent disagreed.

The inherent complexity of financial products can also inhibit rational decision-making. Many people lack the ability to match their risk ‘preferences’ with the right kinds of financial products (Sunstein and Thaler 2003). Because of the publicity surrounding prominent financial failures (e.g. Centro and Westpoint in Australia) and the fear of losing money, many people may be unduly conservative in their investment decisions, for example choosing ‘capital stable’ or ‘capital guaranteed’ rather than ‘growth’ products. Such tendencies are exacerbated by basic misunderstandings about the difference between nominal and real returns on investment (Bertrand *et al.* 2005).

#### *Lack of planning, procrastination and inertia*

According to orthodox economics, individuals attempt to stabilise their level of consumption over the course of their lives. Young people, who tend to have relatively modest incomes, will go into debt to fund their consumption while those in middle age, who tend to have higher incomes, will be net savers. Upon retirement, people then draw on their pool of savings at a higher rate than they would otherwise earn by investing that money. Such ideas, known as the ‘life cycle hypothesis’ or alternatively the ‘permanent income hypothesis’, were developed by Franco Modigliani and Milton Friedman in the 1950s and 1960s (Friedman 1957; Deaton 2005).

In reality, the balance between consumption and saving over the life course is rarely so calculated. According to Mitchell and Utkus (2004, p. 9):

A ‘planner’ paradigm, where the individual consciously pursues retirement saving and investment goals in a disciplined, systematic way, appears to apply to only about half of the retirement plan population. The other half appears singularly unable to impose the self-control needed to solve this problem.

It has been suggested that the failure to plan properly for retirement is not due to financial incompetence so much as the lack of a ‘visceral’ sense of danger (Weber 2004). There is also a morbid aspect to retirement preparation, given that ‘any contemplation of one’s eventual demise and death is existentially disquieting and unpleasant’ (Weber 2004, p. 62).

Behavioural economists refer to the tendency of people to place much lower value on future benefits as ‘quasi-hyperbolic discounting’ and compare it to ‘exponential discounting’ where value falls more smoothly as time progresses (Laibson 1997;

O'Donoghue and Rabin 1998).<sup>13</sup> Procrastination, otherwise known as 'status quo bias', is an extremely common behavioural trait (Samuelson and Zeckhauser 1988). Previous research by The Australia Institute showed that around one in three Australians 'often put off financial decisions until later' and that consolidating multiple super accounts is one of the most common examples of this (Fear 2008). Other studies have documented the yawning gap between people's stated intentions and actual behaviour (Mitchell and Utkus 2004). Simple barriers, such as the need to fill out and submit a form, can prevent people from acting in their own best interests. When applied to financial decision-making, procrastination can over time result in significant losses to people who fail to take advantage of better options. Australian research has shown that superannuation fund members are quite susceptible to status quo bias, with many declining to change funds when they would benefit from doing so (Fry *et al.* 2007). This finding is supported by low switching rates since the introduction of Choice of Fund (see Chapter 3).

Research also shows that men and women approach retirement planning in different ways. Men tend to change their retirement plans in response to job loss and job insecurity, whereas women tend to respond to changes in their health or their partner's health (Cobb-Clark and Stillman 2006). This may be due to differences in risk perception, with women judging 'health, safety, and recreational risks' and 'financial and ethical risks' to be more substantial than men appear to (Weber 2004, p. 55).

Other Australian research has borne out these findings. An ASIC study found that most people do not contemplate how they will structure their retirement incomes until retirement is imminent. The majority think little about superannuation until there is a specific trigger, such as poor health or job loss, that highlights the importance of doing so (ASIC 2004). The disinclination to plan properly is especially pronounced among young people: a survey by BT Financial Group found that 83 per cent of young men and 73 per cent of young women plan to live off their partner after they turn 50 (Corby 2007). Even among people with 'direct' investments in shares, investment properties or managed funds there is a failure to plan properly, with a more recent study by ASIC finding that 37 per cent of such investors do not have a long-term financial goal or a plan to reach it (ASIC 2008, p. 28).

These insights are supported by the findings of an Australia Institute survey on how people expect to fund their retirement. Survey respondents were asked whether, when they retire, they expect to be fully dependent on the age pension, partly dependent on the age pension, or a fully self-funded retiree. Fifteen per cent of (non-retired) respondents expected to be fully dependent and 40 per cent partly dependent on the pension, meaning that more than half (55 per cent) expected to have to rely to some extent on the pension when they retire. A further 30 per cent said they expected to be fully self-funded retirees, while 15 per cent were unsure.

As Table 5 shows, a higher proportion of men expected to be fully self-funded in retirement; 35 per cent of men who had not already retired, compared with 27 per cent of women, selected this option. For their part, women were more likely than men to

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<sup>13</sup> 'Exponential discounting' refers to a constant rate of reduction in value over time, whereas 'quasi-hyperbolic discounting' places a higher rate of reduction in value over the short term and a relatively low rate over the long term (Laibson 1997).

be *unsure* how they would fund their retirement (17 per cent as against 12 per cent for men).

Younger people were much more likely than older respondents to see themselves as being self-sufficient in retirement. As shown in Table 5 (below), only 45 per cent of 18–34 year olds expected to be fully or partly dependent on the age pension compared with 61 per cent of 35–54 year olds and 68 per cent of those over 55. Naturally enough, younger people were at the same time more unsure (18 per cent) about how they would fund their retirement compared with 35–54 year olds (14 per cent) and those over 55 (six per cent).<sup>14</sup> Overall, the relatively low proportion of people who expect to be fully self-funded in retirement suggests that many find it difficult to determine the required level of saving needed to support their retirement.

**Table 5 ‘When you retire, would you expect to be ...?’\***

	Male	Female	18–34	35–54	55+**	All
Fully dependent on the age pension	15%	15%	10%	20%	18%	15%
Partly dependent on the age pension	38%	41%	36%	41%	49%	39%
A fully self-funded retiree	35%	27%	37%	26%	27%	31%
Not sure	12%	17%	18%	14%	6%	15%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

\* Base=735. Excludes respondents who reported being fully or partly retired.

\*\* Figures in this column should be treated with caution due to small sample size.

The survey also asked whether respondents expected the age pension to be available by the time they retire. Significantly, as shown in Table 6, one in eight people who said they would be dependent on the pension (12 per cent) also expected that the age pension would not be around by the time they retire, indicating a clear contradiction in their expectations for retirement. A further 32 per cent were not sure whether the pension would be there. Put another way, almost half of those who expected to be dependent on the age pension in retirement did not expect it would be around when they retire.

Naturally enough, there were also different expectations about the age pension among people of different ages, as Table 7 shows.

<sup>14</sup> Some of this uncertainty may relate to expectations about inheriting money (in addition to the uncertainty about employment-derived income); some people who expect to be ‘self-funded’ may in fact rely on an inheritance. Generally speaking however, dependence on inheritance money is declining as people (both parents and children) live longer.

**Table 6 Expected status of age pension by expected source of retirement funding\***

	Dependent on pension	Self-funded retiree	Not sure	All
Age pension will be available	56%	34%	27%	45%
Age pension will not be available	12%	42%	17%	22%
Not sure	32%	24%	56%	33%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

\* Base=735. Excludes respondents who reported being fully or partly retired.

**Table 7 Expected status of age pension by age\***

	18–24	25–34	35–44	45–54	55–64**	All
Age pension will be available	38%	34%	36%	60%	81%	56%
Age pension will not be available	29%	25%	28%	13%	6%	19%
Not sure	33%	41%	37%	28%	13%	25%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

\* Base=735. Excludes respondents who reported being fully or partly retired.

\*\* Figures in this column should be treated with caution due to small sample size.

### *Mental accounting*

Self-control and the ability to translate intentions into actions are of particular relevance in retirement planning where people must save continually for many years. People often realise that they lack the self-control to act prudently all the time so they take measures to ‘impose’ control on themselves. For example, observers have noted that people distinguish, in ways that are not always rational, between ‘categories’ of money destined for different purposes, even though money is usually completely fungible (that is, one dollar is the same as any other dollar). Richard Thaler has termed this phenomenon ‘mental accounting’, and has documented how people place their (present and future) money into different categories even when this jeopardises their overall financial situation.<sup>15</sup> As he points out, ‘the violation of fungibility (at obvious economic costs) is caused by the household’s appreciation for their own self-control problems’ (Thaler 1985, p. 200).

<sup>15</sup> Thaler provides the following example of financial irrationality based on different mental ‘accounts’: ‘Mr and Mrs J have saved \$15,000 toward their dream vacation home. They hope to buy the home in five years. The money earns 10% in a money market account. They just bought a new car for \$11,000 which they financed with a three-year car loan at 15%’ (Thaler 1985, p. 199).

Survey findings shed light on mental accounting and self-imposed control in the area of voluntary superannuation. Survey respondents were asked whether they agreed or disagreed that ‘voluntary superannuation contributions are a good way of forcing myself to reduce my spending and save more for retirement’. Excluding those who were already fully retired, more than half (59 per cent) agreed while only 11 per cent disagreed. Women were more likely to agree with this statement, and people over 55 were more likely to agree than were younger respondents.

People who were making voluntary super contributions were much more likely than those who were not to agree that these contributions are a good way of forcing them to save more for retirement. Table 8 shows the extent of agreement with this statement by those respondents who both had and had not made voluntary contributions to their superannuation in the previous 12 months. Three in four of those making voluntary contributions (76 per cent) agreed as against one in two of those who had not made any voluntary contributions in the previous 12 months (52 per cent). In fact, only four per cent of those who were making voluntary super payments disagreed, compared with 14 per cent of those who were not making payments.

**Table 8 ‘Voluntary superannuation contributions are a good way of forcing myself to reduce my spending and save for retirement’\***

	Voluntary super contributions in previous 12 months (n=228)	No voluntary super contributions in previous 12 months (n=604)**	All (n=832)
Agree	76%	52%	59%
Disagree	4%	14%	11%
Neutral	20%	33%	30%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

\* Excludes respondents who reported being fully retired.

\*\* ‘No voluntary super contributions’ includes 17 respondents who said they were *unsure* whether they had made any voluntary super contributions in the previous 12 months.

Focus group participants were also asked whether they contributed to superannuation on a voluntary basis. Only a few young people reported doing so. These were generally women and most had decided to do so based on their parents’ encouragement.

*Dad said, “It is the easiest money you’re ever going to make”. (18–29, Sydney, higher income)*

Quite a number of middle-aged participants were salary sacrificing into their super, although these people tended to be on higher incomes. In the older age groups, the majority of participants, irrespective of income level or gender, were contributing additional income into superannuation (apart from those who had already retired).

Among those who were making additional super payments, there was strong agreement that voluntary super contributions are an effective method of stopping themselves from spending that money in the future. This did not appear to be because of the tax benefits associated with depositing savings in a super account. Instead, super payments were said to occupy a separate space or ‘account’ in people’s minds because it remains untouchable (except in exceptional circumstances) until retirement. This was particularly the case for those who still had some years until retirement, for whom retirement savings were more an ‘idea’ than a tangible investment.

*I wouldn’t even consider taking it out. I know that’s for my retirement, so I wouldn’t touch it. (30–49, Canberra, higher income)*

*It’s not something that’s visible, so I wouldn’t even think about it. (18–29, Sydney, higher income)*

### *Unstable preferences, framing and heuristics*

One of the chief economic arguments for greater consumer choice is that it allows individuals to map their preferences onto the available options more exactly. However, there are some areas of life where people lack firm preferences, for example in the degree of financial risk they are prepared to shoulder for a given level of return, or for the amount of present consumption they are willing to forego for future wealth. In fact, people’s preferences for particular types of financial products are not fixed; they tend to be ‘situational’ rather than ‘hard-wired’ with the result that ‘preference reversals tend to be more common than might be expected’ (Mitchell and Utkus 2004, p. 16). This suggests that choices about superannuation do not necessarily reflect innate preferences but, instead, the situation or context in which consumers make decisions.

Because context is so important, one of the most significant factors in financial decision-making is how the available options are ‘framed’; that is, how they relate to one another, how they are explained, and what other information is provided at the same time. For example, people have a tendency to ‘avoid extremes’ and ‘pick the middle option’ when given a range of choices (Bernatzi and Thaler 2002). In addition, they have been shown to change their decisions when the same information is presented in different ways, for example displaying past performance in one-year or five-year increments (Bernatzi and Thaler 2002). In fact, the research indicates that the way options are presented is ‘a more powerful influence on participant decision-making than the underlying risk and return characteristics of the investments being offered’ (Mitchell and Utkus 2004, p. 16).

The power of framing is one reason why financial institutions, including superannuation fund managers, spend so much on advertising and marketing. Because of the complexities involved, advertising about financial products tends to be of the ‘emotive’ rather than the ‘informative’ kind. Unfortunately, this kind of advertising has been shown to have a negative impact on the portfolio choices that investors make (Cronqvist 2003).

The influence that framing has on financial decisions relates to what psychologists call *heuristics*: mental rules or shortcuts that people use when they have no clear preference for one option over another, or where the cost of acquiring information is

too high. Heuristics allow people to make complex decisions even when they have incomplete information, and some are particularly important for financial decision-making. For example, the principle of *social proof* encourages individuals to ‘do what other people do’ and *reliance on authority* to ‘do what informed people do’. The *representativeness heuristic* means that people tend to perceive patterns in otherwise random data, an important behavioural trait in the area of financial investments. Similarly, the principle of *scarcity* enables salespeople to place pressure on potential buyers with the threat that a good deal might lapse if not taken up immediately (Cialdini 1993). According to one psychological account:

We are likely to use these lone cues when we don’t have the inclination, time, energy, or cognitive resources to undertake a complete analysis of the situation. Where we are rushed, stressed, uncertain, indifferent, distracted, or fatigued, we tend to focus on less of the information available to us (Cialdini 1993, p. 275).

Heuristics persist because they are of great use in some areas of life, such as social encounters, where their effects on ‘welfare’ are often positive or at worst trivial. In the complex realm of personal finances, however, heuristics can lead to persistent biases in decision-making, resulting in significant financial costs. For instance, the *availability heuristic* is the tendency to use readily available information rather than seeking something more relevant to the decision at hand. A common rule of investing is that past performance is no guide to future performance, yet some people rely solely on past performance to choose an investment fund. Such data is easily available and fund managers often use past performance to market their services and demonstrate that they can ‘beat the market’.

#### *The desire for fairness*

Behavioural research indicates strongly that people act in ways that benefit others without requiring anything in return. This runs counter to the notion that people rationally appraise individual costs and benefits before making a decision, a key principle underlying orthodox economic theory (Dawnay and Shah 2005). In superannuation, the trade-off between individual and social benefits applies particularly to the issue of ethical investment.

Survey participants were also asked to respond to the statement ‘I would prefer my superannuation fund to invest in more ethically responsible ways’. Forty per cent agreed while only 15 per cent disagreed; a further 44 per cent remained neutral or were unsure. People under 55 were more likely to agree with this statement. Respondents with lower household incomes (under \$40,000 per annum) were also more likely to agree than those on middle incomes (\$40,000–\$80,000 per annum), who were in turn more likely to agree than those with an annual household income greater than \$80,000.

Meanwhile, shareowners were less likely than those without shares to agree that their superannuation funds should invest more ethically, although shareowners still agreed overall. Interestingly, people who said they did not have a good understanding of finances and investments were more likely to agree that their super fund should invest in more ethically responsible ways than respondents who said they did have a good understanding.



Several older people raised the issue of exactly how superannuation funds are invested, an issue not discussed in any of the younger or middle-aged groups. They were concerned that they had no information on the exact nature of their investments and suspected that some fund managers act in ways that are ethically dubious or purely profit-driven.

*If you look at the dodgy stuff some of these companies do, they justify everything on the basis of maximising returns to shareholders. (50–70, Adelaide, higher income)*

*Sooner or later, if greed isn't limited, it's going to become a destructive force. (50–70, Adelaide, higher income)*

No one had changed super funds due to such concerns (although some had sold shares in corporations perceived to have acted unethically), but this was regarded as a serious issue, particularly as there is very little information available on the actual nature of investments beyond that provided by ethical investment funds. With so much money now tied up in Australian superannuation funds, there was a feeling that this should contribute to nation-building and long-term infrastructure rather than speculation and profiteering.

*They're putting all this super money into shopping centres and things we don't need, rather than important stuff like infrastructure. (50–70, Adelaide, lower income)*

*We don't know where the money is invested. I'd hate to think that there's so much money invested in things that are only financial rewarding and not useful in other ways. (50–70, Adelaide, lower income)*

*I'd like to think there's profit in ethical investments. (50–70, Adelaide, higher income)*

*At the end of the day, we're interested in how much we're going to get from our super. So maybe the less we know the better. (50–70, Adelaide, higher income)*

*The government has frightened us into thinking we need to support ourselves. So we just concentrate on how much we're going to get from our super. (50–70, Adelaide, higher income)*

Some people felt that the super system is deliberately structured to encourage the consent of the 'investors' in what would otherwise be regarded as morally questionable economic activity.

*If we weren't all shareholders of Woolworths through our super, would they get away with it? (50–70, Adelaide, higher income)*

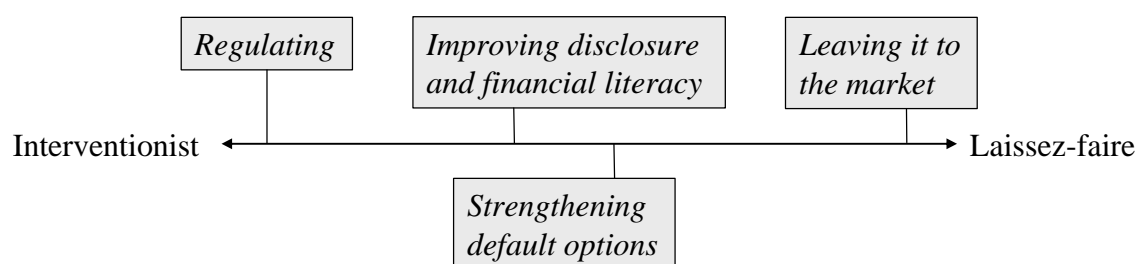
*We're guilty by association—all of us that have super funds. (50–70, Adelaide, higher income)*

## 4.2 Implications for superannuation policy

Implicit in the idea of compulsory superannuation is an acknowledgement that consumers very often do not behave in economically rational ways. That is why many people are unlikely to save enough for retirement in the absence of a system that compels them to do so.

Several of the key players in the field of superannuation have acknowledged that the lessons of behavioural economics also apply to superannuation. For example, the PJCCFS reported that people fail to seek out financial advice due to ‘a combination of apathy, inertia and a perception of those with low or moderate fund balances that the cost and effort would not justify the benefits ... Also important is a belief that the fund managers are experts and will do a good job’ (PJCCFS 2007, p. xviii). The peak group in the superannuation industry, ASFA, has said that ‘in the absence of involvement of financial planners there are actually grounds for believing that the more investment choices that are available, the less likely a member is to actively exercise a choice’ (quoted in PJCCFS 2007, p. 55).

Given the recognition that consumers often depart from ‘rational’ behaviour in making financial decisions, there are various options open to policy-makers to ensure that consumers derive maximum benefit from the superannuation system and are adequately protected. These range from laissez-faire approaches, which would allow the market to decide how best to appeal to consumer ‘tastes’, to highly interventionist approaches, such as re-regulating the financial sector (see diagram below). Between these two extremes lie other options, but most of these have significant limitations or are applicable only in certain contexts, as explained below. For that reason, we explore in detail the potential of default options in providing additional benefits to workers who do not make active choices about their superannuation.



### *Leaving it to the market*

The first policy option is to leave the problem to the market. In theory, this will encourage providers to simplify and explain their products in ways that will appeal to consumers. In reality, the result of such an approach to superannuation has been that funds with relatively high fees and charges continue to thrive (as Chapter 3 has shown). Allowing market mechanisms to solve the complexity problem in the retail financial sector is ineffective because long-term financial products differ from other consumer goods in crucial ways: they are purchased infrequently, their value is unclear at the time of purchase, and it can be very difficult to verify the claims made by financial suppliers (Consumer and Financial Literacy Taskforce 2004). Because there is such a long time between making a ‘purchase’ and enjoying the benefits, it is usually too late or too costly to reverse a poor decision. There is also evidence that

consumers who rely on fund advertising for information tend to make poorer financial decisions, particularly where such advertising is of an ‘emotive’ rather than an ‘informative’ nature (Cronqvist 2003).

Of course, government plays a crucial role in protecting consumers against the various risks associated with financial investments. Agencies such as ASIC and the ACCC have the power to bring financial providers to court when they are deemed to be in breach of the law. They are also involved in educating consumers about the dangers of financial scams, for example through ASIC’s website [www.fido.gov.au](http://www.fido.gov.au).

Nevertheless, consumer protection measures like this relate to illegal (or potentially illegal) conduct. They cannot shield consumers from making poor financial choices where there is no breach of the law, for example remaining with a superannuation fund that charges excessive fees. Instead, in a deregulated sector like financial services, policy-makers tend to rely on market forces to lower costs. In other words, basic consumer protection is unable to correct many of the natural behavioural biases that can affect financial decision-making.

### *Regulating*

Rather than relying on competitive forces to bring consumer benefits, government can intervene directly by circumscribing exactly what kinds of financial services can be provided and under what conditions, even beyond the need to shield consumers from illegal or fraudulent activity. For example, prior to the Hawke Government’s sweeping financial reforms in the mid-1980s, there were restrictions on how banks could invest money and what interest rates they could charge home mortgage customers. Financial deregulation has progressed steadily since that time; in superannuation, the apotheosis of deregulation occurred in 2005 with the introduction of Choice of Fund (Nielson 2008a).

Stakeholders in the superannuation system (and particularly the funds themselves) are likely to oppose vehemently any measures that increase the level of regulation. The Rudd Government has also stated its commitment to furthering the deregulation agenda across the board; it has even renamed one of its central agencies the Department of Finance and Deregulation. Nevertheless, research suggests that certain kinds of regulation in superannuation, for example compelling funds to limit the options that members have to choose from, may in fact lower administrative costs (Langford *et al.* 2006; Vidler 2004).

### *Improving financial literacy*

A third policy option is to alleviate the ‘information asymmetry’ between financial providers and consumers through measures designed to encourage greater financial literacy and capability. Such measures have been pursued across the developed world in recent years in the wake of widespread financial deregulation. Many Australian financial institutions now have financial literacy initiatives in place, and the Australian Government established the Financial Literacy Foundation in 2006.<sup>16</sup> The National Information Centre on Retirement Investments is also funded by the

<sup>16</sup> For a more complete overview of government initiatives in the area of financial literacy, see Fear, J (2008) *Choice Overload: Australians Coping with Financial Decisions*, Discussion paper 99, The Australia Institute.

Australian Government to provide independent information on superannuation (although not ‘personal advice’) to consumers.

While greater financial proficiency would clearly benefit many people, the power of financial education to influence behaviour is questionable. With so many commercial messages vying for consumers’ attention, including advertising by financial providers, the impact that a financial literacy campaign can have is necessarily limited. Moreover, greater financial knowledge does not necessarily translate into more discerning financial decisions. The behavioural biases described above apply across the population spectrum and are not confined to subsets of the population such as those with less education (Sunstein and Thaler 2003; Gallery 2002). The independent research firm SuperRatings told the recent parliamentary inquiry into superannuation that the issue of financial literacy is ‘thrown up too often before we have even sorted the macro position, which is that Australians do not care about super’ (PJCCFS 2007, p. 175).

Although it is a critical part of the policy response, relying exclusively on financial literacy to address non-rational financial behaviour places the onus of responsibility squarely on the consumer and neglects the fundamental responsibilities of governments and financial providers to present consumers with choices that they understand and value. The consequences of such an approach are predictable: many Australians will continue to make decisions that are not in their financial best interests. Instead, steps need to be taken to lower the psychological costs of understanding information pertaining to financial products and services.

### *Improving disclosure*

Like financial literacy, the nature and extent of financial disclosure directly affects consumers’ ability to interpret financial information. One of the most important elements of the Coalition Government’s sweeping reforms to the financial sector under the *Financial Services Reform Act 2001* (Cth) was in the area of information disclosure. Under these changes, all financial providers were required to make comprehensive information about their products available through a Product Disclosure Statement, a Financial Services Guide and (for financial advisers) a Statement of Advice. An unintended consequence of FSR has been the labyrinthine documentation that financial providers now produce in order to cover themselves against the legal risks associated with non-disclosure—and which consumers generally disregard (Fear 2008). And, despite a number of modifications to the FSR regime since 2001, much of the information provided to consumers by financial providers continues to be overly complex. Superannuation funds have complained that ‘FSR restrictions on targeted educational material [have] fostered a conservative approach to educating members about their options, denying them an important source of information’ (PJCCFS 2007, p. 173). FSR has also made it more difficult to access affordable financial advice because of strict disclosure requirements (PJCCFS 2007).

The Rudd Government has taken some steps to improve the disclosure system, for example by introducing short (four-page) product disclosure statements for its First Home Saver Accounts (Sherry 2008b). However, there are obvious limits to what effective disclosure can achieve, particularly in an area like superannuation where many consumers remain disengaged.

### *Strengthening default options*

A further option open to policy-makers wishing to offset the negative effects of behavioural biases in superannuation is to use well-designed default arrangements. These would make automatic decisions on behalf of fund members unless they make a choice to the contrary. Research has shown that people often interpret default arrangements as imparting ‘information about how sensible people usually organise their affairs’ (Sunstein and Thaler 2003, p. 1180), and there is widespread consensus in the behavioural economics literature on the benefits of well-structured default arrangements in retirement investments.

Behavioural finance and economics ... challenge the notion that pension plan design is a neutral vehicle within which participants make their own choices independently. Because of default, framing, and inertia effects ... the design of a retirement system or plan has a profound effect on participant investment and saving decisions. Sponsors and policymakers can alter behavior in fundamental ways by choosing different default structures (Mitchell and Utkus 2004, p. 31).

Australia’s superannuation system already includes some default or automatic elements. If a new employee declines to choose a superannuation fund, they are placed in their employer’s nominated fund. If a new fund member declines to choose an investment mix, as about half of all fund members do, they are placed in the fund’s default investment strategy, which is usually subject to careful deliberation by the fund trustee. Moreover, in some senses, even the SG itself is a default strategy in that a set proportion of each employee’s income is preserved on their behalf until retirement age.

In many cases, an employer’s ability to choose the fund into which they lodge superannuation contributions on behalf of their employees is restricted by industrial regulation. The naming of specific default funds in awards and other industrial agreements is another ‘default’ mechanism, which relieves the majority of employers of the burden of having to research and choose an appropriate default fund.

Awards are determinations by the industrial relations umpire, the Australian Industrial Relations Commission (AIRC),<sup>17</sup> that establish minimum and binding employment conditions for specific sectors of the workforce. These are default minimum conditions that can be overridden by formal written agreements between an employer and the employer’s workforce or, in limited circumstances,<sup>18</sup> individual employees.

Employment regulation via the award system has had an important impact on the default arrangements that apply to employees who fail to exercise choice. In addition to the 19 per cent who are totally reliant on minimum award conditions, 32 per cent of employees have their terms and conditions established by unregistered individual agreement, where the default superannuation arrangements found in the relevant award are also likely to apply. A further 41 per cent of employees are subject to a registered agreement, which also usually reflects the default superannuation arrangements set out in the relevant award (ABS 2006). We therefore estimate that for

<sup>17</sup> As of 1 January 2010 to be renamed Fair Work Australia.

<sup>18</sup> Recent changes to industrial law have restricted the circumstances under which an employer may offer an individual contract of employment.

between six and 16 per cent of the workforce, the nomination of the default fund is up to the discretion of the employer, while 64 to 74 per cent have a default fund specified through industrial arrangements. A further 20 per cent of the workforce is ineligible for Choice of Fund for various reasons (see Chapter 2).

As part of a major revision of Australia's employment standards, the AIRC has been directed by the Federal Government to develop consolidated, simplified and national awards. It is expected that the coverage of these new modern national awards will be more extensive than the current system. This is likely to mean that the proportion of the workforce whose default fund is specified by industrial arrangement (rather than by employers) will increase.

Because both employer and employee representatives are party to the negotiation process, this acts as a safeguard mechanism to ensure that the superannuation funds stipulated through the industrial process meet the needs of both parties. Funds, which have tended to gain the most support amongst both employers and employee representatives, have generally been not-for-profit funds with joint employer and employee trustee representatives. Because not all employment relationships are governed by awards, default funds are not always nominated through the industrial process. In such circumstances, employers need to make a decision about the default fund that will apply to their workers.

In addition to existing default or automatic elements within the Australian superannuation system, further default mechanisms have been proposed. For example, ASFA advocates the notion of 'soft compulsion', which would draw additional savings from a worker's income unless they choose otherwise (Clare 2007). Soft compulsion is predicated on the conviction that the present SG rate is not sufficient to meet the financial needs of fund members in retirement. Schemes similar to the ASFA proposal are in place in the UK and New Zealand, where there is no base level of retirement saving (Nielson 2008b).<sup>19</sup> ASFA cites survey research showing strong community support for the idea of soft compulsion (Cameron and Gibbs 2006).

Other proposals for default arrangements in superannuation have been designed to address excessive fees and charges rather than the rate of savings. Prior to Choice of Fund, Brown *et al.* (2002) floated the notion of a government-run 'Universal Default Fund', which would protect 'passive investors' against poor fund choices by directing them into a single, government-managed investment vehicle. More recently, Sy (2008b) has argued that a national default option based on the 'proportionate shareholding approach' (i.e. investing across the Australian Stock Exchange rather than actively managing the investment mix) would result in much lower management fees. He estimates that such an approach could 'save fund members up to \$20 billion per year' and 'potentially double the terminal wealth accumulated by a worker through superannuation over a working life'. This default investment strategy could, he contends, bring the management expense ratio down to as low as 0.1 per cent (Sy 2008b, p. 23–4). While these proposals are based on strong economic analysis, real-life consumer experiences also need to play a part in the design of default provisions for the superannuation system.

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<sup>19</sup> The New Zealand scheme, called Kiwisaver, is an opt-out system while the UK's Stakeholder Pension is an opt-in system (Nielson 2008b).

### 4.3 Principles for good default options


It is not the purpose of this paper to assess whether Australia's current level of private retirement savings is adequate. It does not therefore consider the merits of soft compulsion or other possible measures to increase superannuation contributions beyond nine per cent. However, it does seek to identify default options, which address other critical shortcomings of the present superannuation system.

Using focus group and survey research with Australians and the behavioural economics literature, we can identify a number of principles upon which default arrangements should be based. These are as follows.

- Australians value autonomy in relation to their financial affairs but many are frustrated with the complexity of the superannuation system and would prefer simpler choices to be available. Default options are an effective way to protect those people who struggle to make good financial choices in a complicated financial environment. *Default arrangements should therefore be simple and effective, while allowing participants to opt out if they prefer more choice or flexibility.*
- People are subject to a range of behavioural biases, which can negatively affect the decisions they make about retirement. *Default options should therefore embody a rational approach to retirement preparation in the interests of fund members, without the need for costly financial advice.*
- People tend to make poor financial decisions in situations where benefits will be realised only in the distant future. *Default options in superannuation should therefore focus especially on the needs of people who are a long way from retirement, or whose accumulated benefits are relatively modest.*
- Despite their stated intentions, many people will not make the best choices about their super fund or their investment strategy. *Default options should therefore be structured to maximise asset accumulation by allocating investments appropriately and minimising fees.*
- Australians want the superannuation system to be fair to fund members and to society as a whole. *Default options should therefore promote fairness in the way that assets are accumulated and invested.*
- People without financial expertise are susceptible to misleading messages in the area of retirement investments. *Default options should therefore be designed to reduce the likelihood that fund members will make decisions based on how choices are presented rather than on their inherent financial value.*

In the final chapter, these principles are incorporated into a set of criteria for the accreditation of default funds. Such criteria are important for providing both workers and employers with the assurance that their default fund meets basic standards relating to fees, investment strategy and ease of administration. The need to have some sort of criteria for default funds to protect members was first identified when Choice of Fund was initially proposed in 1998, but no criteria were implemented when legislation was finally introduced in 2004. Instead, it was assumed that

competition would suffice to deliver good outcomes for consumers.<sup>20</sup> As this paper has argued, competition has not resulted in a better deal for fund members and it is time that additional standards for default funds were established to protect those who choose not to choose.



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<sup>20</sup> In the 1998 Senate Select Committee inquiry into Choice of Superannuation Fund, the Australian Consumers' Association (CHOICE) argued that 'the employer has a responsibility for those members of staff who do not choose to move funds to provide an alternative that meets basic criteria ... there must be minimum standards of performance for funds that are eligible to have that default characteristic' (Bun 1998).



## 5. Conclusions and recommendations

In Australia's compulsory superannuation system, workers are faced with an extensive array of choices about which fund they join and how their savings are invested. Yet many people decline to make active choices about their super and some make choices that are not in their financial best interests. As this paper has argued, recent policies designed to extend choice and competition have not delivered optimal outcomes for many fund members. In a hybrid superannuation system combining choice and flexibility with compulsory saving, good default systems are paramount. This is especially the case where workers enter a fund by default rather than through active choice.

Under the present system, responsibility for nominating a super fund for those workers who do not choose a fund rests with employers except in instances where a default fund is specified in an industrial agreement or award. This is a difficult decision for employers to make and, under current arrangements, there are no mechanisms to ensure that the needs of employers and employees coincide. Default funds nominated in industrial awards often already adhere to many of the principles for good default arrangements. This may in part follow from the fact that both employer and employee representatives need to agree on which funds will best suit their mutual interests. These tend to be industry, non-profit and (sometimes) corporate funds, which often have joint employer-employee trustee arrangements.

Based on the principles for good default options set out in Chapter 4, we propose a new mechanism for the selection of default funds where the responsibility for selecting the fund rests solely with the employer. This would ensure that workers who choose not to choose get a good deal, while also making matters easier for employers. In order to be accredited as an *eligible default fund*, a fund would need to comply with a set of criteria as set out below; these would benefit employees by lowering fees and protecting savings, and employers by reducing the costs associated with administration and selecting an appropriate default fund. Employers would then be able to pick any eligible default fund and be certain that it would meet minimum standards and represent a fair deal for their employees. Inclusion on the list of accredited funds would be determined by a government adjudicator (e.g. APRA), and funds would be monitored to ensure compliance.

There are six proposed criteria for accredited default funds, which together provide a 'safety net' for workers who choose not to choose.

*1. Cap ongoing fees and charges.* The maximum fee should be determined by an independent regulator such as APRA. As with the current private health insurance regime, funds could apply to increase their fees but would need to demonstrate that the increase results from genuine additional costs or additional value for fund members.

*2. Prohibit entry and exit fees.* One-off entry fees should not apply where workers are assigned to the default fund because they have declined to make an active choice. Similarly, exit fees discourage people from making active decisions about their super and consolidating multiple accounts. Transaction and investment costs associated with

the initiation or termination of an account should therefore be captured in ongoing management fees (see criterion 1).

*3. Prohibit the payment of ongoing financial advice fees, including commissions.* If workers are placed in the default fund, by definition they have not made an active decision about their superannuation fund. It is therefore unlikely that they have received any formal financial advice at their instigation. Prohibiting the deduction of ongoing advice fees from default funds ensures that members' savings are not unnecessarily eroded and that members are not charged for advice that has not actually been received. Should members seek superannuation-related advice from a financial planner, they may authorise for the fee for this advice to be deducted from their superannuation account as a fixed amount.

*4. Offer employers a clearinghouse service.* Employees who exercise Choice of Fund currently place additional administrative costs on employers. Many super funds already offer a clearinghouse facility, which processes payments to multiple funds. This should be a standard element of the superannuation system and default funds should accept contributions from any clearinghouse source. When a person changes jobs, they should automatically retain their former default fund unless they make an active choice to the contrary, irrespective of the new employer's nominated default fund. The clearinghouse would then become the mechanism for channelling contributions from the new employer into the default fund. This arrangement preserves one of the important beneficial features of the present system, the ability to take a super fund from one job to the next. It would also lower administrative costs for employers who would then be more likely to make decisions about default funds in the best interests of their employees.

*5. If contributions cease, keep members in the default fund.* Some super funds automatically transfer their members to a more expensive 'personal plan' or to an external ERF if no employer contributions are received within a certain period. Many ERFs and personal plans charge higher than average fees and deliver poor investment returns. To avoid the erosion of worker savings due to personal circumstances like illness, parenthood or job loss, members should not be transferred to a more expensive ERF or personal plan without their explicit consent.

*6. Automatically follow up arrears in payments.* Although most employers meet their superannuation obligations, some shirk their responsibilities. Default funds should establish a mechanism to identify and respond to situations where full contributions have not been paid. This may involve alerting individual members that payments are missing, or it could mean notifying a government agency such as the ATO.

Many Australians have declined to exercise choice about their super fund, and there is confusion and uncertainty in the community about exactly how super moneys are invested. Our research shows that many people would value the opportunity to use their superannuation to invest in socially purposive or desirable activities—that is, for 'nation-building'. Policy-makers should therefore provide fund members with more opportunities to invest in such endeavours and the ability to make simple choices about this. For their part, super funds should consider the ethical and environmental implications of their investments and better communicate these to members.

## Appendix A—Focus group and survey methodology

The empirical research findings reported in this paper were derived from a number of sources. These were:

- A series of six focus groups organised and conducted by The Australia Institute
- An online survey commissioned by The Australia Institute and conducted by Research Now
- A telephone survey commissioned by Industry Super Network and conducted by Newspoll
- A telephone survey commissioned by Industry Super Network and conducted by New Focus.

The methodology for each of these research exercises is described below.

### Focus groups

#### *General specifications*

Topic	Expectations for the future
Number of groups	6
Participants	Recruit 9 for 7/8
Gender	Mixed
SES	3 x lower, 3 x higher (see below)
Age	2 x 18–29, 2 x 30–49, 2 x 50–70 (see below)
Lower SES (18–29)	<i>Personal</i> income before tax <i>below</i> \$30,000 per annum
Higher SES (18–29)	<i>Personal</i> income before tax <i>above</i> \$30,000 per annum
Lower SES (30–49)	<i>Household</i> income before tax <i>below</i> \$70,000 per annum
Higher SES (30–49)	<i>Household</i> income before tax <i>above</i> \$70,000 per annum
Lower SES (50–70)	<i>Household</i> income before tax <i>below</i> \$60,000 per annum
Higher SES (50–70)	<i>Household</i> income before tax <i>above</i> \$60,000 per annum

*Group breakdown*

	Lower SES	Higher SES
18–29	Group 1: Sydney West 6pm Monday 22/10	Group 2: North Sydney 6pm Tuesday 23/10
30–49	Group 3: Wollongong 6pm Tuesday 30/10	Group 4: Canberra 6pm Thursday 1/11
50–70	Group 5: Adelaide 6pm Tuesday 7/11	Group 6: Adelaide 6pm Wednesday 8/11

*Additional specifications*

- Groups 1 and 2 must include people still living at home (at least three) and people who have moved out of home (at least three).
- All participants in groups 1, 2, 3 and 4 must work in a paid job for at least seven hours per week OR live with a partner who works in a paid job for at least seven hours per week.
- Groups 3, 4, 5 and 6 must include at least four participants who attend with their partner (i.e. two couples per group).
- In groups 5 and 6 a good mix of fully retired, semi-retired and non-retired people is desirable.
- In each group, a range of ages and genders is required.

*Venue details*

Sydney West venue	Focal Point group rooms 93 Wigram Street, Harris Park
North Sydney venue	The Chatroom Facility Level 1, 431 Miller St, Cammeray
Canberra venue	Fellows Room, University House Australian National University, Canberra City
Wollongong venue	Corrimal RSL 168 Princes Hwy, Corrimal
Adelaide venue	Robyn Kunko Market Research 7 Hill Court Black Forest SA

## Online survey

The online survey sample was drawn from an online panel of ‘pre-recruited’ respondents and was designed to be nationally representative by gender, age, income and state/territory. The Valued Opinions Panel, owned and managed by the Australian arm of Research Now, was used to source respondents. It is a research-only panel (i.e. panel lists are not used to carry out any non-research activities such as marketing) recruited from a wide variety of sources to avoid any bias associated with limited-source recruitment. The panel recruitment strategy is designed to ensure that a good mix of panel members is captured across each state and across the age, gender and income spectrums. The panel is managed in a manner that complies with the draft ESOMAR guidelines for online panels.<sup>21</sup> Panel members are individually rewarded for their participation in surveys at a level that helps to ensure reliable responses and considered answers to the questions, but not so high as to attract ‘professional’ respondents. In the case of this survey, the incentive for participation was \$1.50 per respondent. A series of checks was run on survey data to safeguard against invalid completes; for example, respondents completing the survey in less time than it would take to give considered responses to each question.

Some results from this survey have already been reported in a Discussion Paper previously published by The Australia Institute, *Choice Overload: Australians Coping with Financial Decisions* (Fear 2008). Except where direct reference is made to this earlier work, the survey findings in this paper are new.

## Telephone survey—financial planners

In early 2008, Industry Super Network commissioned Newspoll to undertake a study of community experiences and attitudes to financial planning. This survey was conducted over the telephone by Newspoll in accordance with the following.

### *Sample*

- Conducted nationally among 1,201 respondents aged 18 years and over.
- Respondents were selected via a random sample process which included:
  - a quota being set for each capital city and non-capital city area and, within each of these areas, a quota being set for groups of statistical divisions or subdivisions
  - random selection of household telephone numbers using random digit dialling (RDD)
  - random selection of an individual in each household by a ‘last birthday’ screening question.

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<sup>21</sup> European Society for Opinion and Marketing Research, the global industry body for market research practitioners and organisations.

### *Interviewing*

- Conducted by telephone over the period of 2 to 4 May 2008 by fully trained and personally briefed interviewers.
- To ensure the sample included those people who tend to spend a lot of time away from home, a system of call backs and appointments was incorporated.

### *Weighting*

- To reflect the population distribution, results were post-weighted to ABS data on age, highest level of schooling completed, gender and area.

### **Telephone survey—tracking attitudes to super**

In 2006, Industry Super Network commissioned New Focus to undertake an ongoing tracking study mapping employee and employer attitudes to superannuation, their awareness of superannuation funds and issues and their superannuation decision-making behaviour. So far, six waves of the study have been completed, all in accordance with the following methodology.

### *Methodology*

Two questionnaires (one for employers and one for employees) were designed by New Focus with input and approval from Industry Super Network. Each questionnaire was formulated with the intention of addressing the aims and outcomes outlined above. Some questions from the Phase 1 questionnaire were included so that responses could be directly tracked in the current study.

Both questionnaires were subjected to an extensive pilot-testing program. Internal pilot tests were conducted to ensure that the flow and wording of the questionnaires were correct. External pilot tests were conducted with a subset of the target market in order to ensure they were appropriate in the ‘real world’ interviewing context. Fifteen ‘cognitive pilot tests’ were also performed on the employer and employee surveys to ensure that there were no shortcomings that could jeopardise the quality of the data collected from the survey.

The employer survey was used to conduct 15-minute interviews with respondents. People interviewed for this survey were the individuals within organisations responsible for administering superannuation. Organisations were randomly selected but quotas for state and organisation size were established so that the sample would be representative of the Australian business community.

The employee survey was used to conduct 15-minute interviews with respondents within the target market: people aged 20 years and over, employed full- or part-time and receiving superannuation payments from employers. The majority of the employee segment comprised individuals randomly selected from the population. However, the employee segment also included a sub-sample of 56 member interviews from industry super member databases supplied to New Focus by Industry Super Network. The employee segment also adhered to state quotas.

A continuous tracking computer-aided telephone interviewing methodology has been employed on an ongoing weekly basis. All interviews were conducted in-house by the New Focus national field team and adhered to best-practice quality standards of Interviewer Quality Control Australia (IQCA), the Australian Market and Social Research Society's Code of Professional Behaviour, and the Market and Social Research Privacy Principles.

*Sample size*

<b>Wave</b>	<b>Number of Employees</b>	<b>Number of Employers</b>
Wave 1	1,015	507
Wave 2	1,604	803
Wave 3	3,066	1,533
Wave 4	2,628	1,314
Wave 5	2,190	1,095
Wave 6	2,336	1,168

*Duration and timing of waves*

<b>Wave</b>	<b>Duration</b>
Wave 1	16 July–2 September 2006
Wave 2	3 September–18 November 2006
Wave 3	19 November 2006–5 May 2007
Wave 4	6 May–1 September 2007
Wave 5	2 September–15 December 2007
Wave 6	13 January–3 May 2008

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