

# NEW LESSONS FROM AUSTRALIA TO IMPROVE PENSION OUTCOMES

## Finance in Focus

Knowledge Notes



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## Pension Funds

The World Bank Group's pension funds team works to improve the coverage of good quality pensions and to increase the supply of pension assets that can safely fund long-term investment. Our work supports financial inclusion and financial integrity, and provides important sources of finance for long-term development including infrastructure. To achieve our goals we work through country and regional engagements, as well as producing research and external outreach.

## The Development Context

Securing income in old age and generating assets to fund development is a rising challenge for developed and developing economies. By 2050 the share of the world's population over age 65 will have doubled from 10% to 20%. Looking to the future, 80% of the elderly – nearly 1.3 billion people - will be living in low-income countries.

Greater economic wealth and security lead to longer lives and smaller families. But a failure to deal with income in old age for this and future generations will mean rising poverty or unsustainable burdens on public finances.

Some of the drivers are irreversible. Shrinking family sizes, the fragmentation of family units, and rising urbanization in low income countries translates into less traditional sources of income support for the aged from the next generation. The danger of inaction is a rise old age poverty. The common challenge is to build pension systems that prevent poverty in old age and improve labor and capital markets through a diversified mix of public and private provision.

There is also a pressing need to increase the stock of assets that support long-term growth and development. Pension funds can be an important sources of domestic, long-term capital which, if structured properly, can help to meet the growing demand for capital to fund businesses, housing and infrastructure.

## Our Response

To meet these challenges the World Bank Group's pension financing team focuses on:

i) Improving the coverage of good quality pensions: Our goal is to ensure that elderly poverty is alleviated by the provision of income in retirement through pension systems that have broad coverage and are adequate, efficient, sustainable and secure. Our work supports financial inclusion and financial integrity.

ii) Increasing the supply of pension assets that can safely fund long-term investment: Promoting the productive investment of pension fund assets not only supports the goal of providing adequate and secure pensions, but also provides important sources of long-term finance for development.

To achieve our goals we work through country and regional engagements, as well as producing research and through our outreach program.

Country and regional engagements take many forms, and involve strong collaboration with World Bank Group colleagues working in the areas such as Social Protection and Labor, Capital Markets and Financial Inclusion. Projects include:

- Designing, reviewing, and reforming the overall pension policy framework in a country
- Drafting, reviewing, and revising the pension legislation and regulatory framework
- Capacity building for supervision of the pension industry – including governance aspects
- Improving pension market structure and dynamics including distribution and access; and
- Reviewing and reforming the fiscal and taxation environment supporting a pension system.

Our research and outreach work involves developing new solutions shared in a range of publications, peer to peer learning through conferences and training, and work with global standard setters and other partners such as the International Organization of Pension Supervisors (IOPS), OECD, IMF, academics, and the pension industry. We are working on a broad range of topics – from reducing costs and improving investment performance to expanding coverage among informal workers. We seek to develop and deliver evidence-based solutions to deliver long-term impacts for countries.

For more details see: [www.worldbank.org/pensionfunds](http://www.worldbank.org/pensionfunds)

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## OVERVIEW AND COMMENTARY

The Australian Government commissioned the independent Financial System Inquiry or ‘Murray Review’ to provide recommendations to improve private pensions (superannuation) – as well as financial system resilience, innovation and consumer protection. This continues Australia’s proactive approach - regularly reviewing how to improve a system that already has good features.

The recommendation for a clear (and legally binding) statement of what the retirement system is trying to achieve is a sensible move. It mirrors what is happening in a range of World Bank projects - to start with the long-run outcomes and then work backwards to find the best ways to achieve them – in terms of regulation, supervision, market structure and efficient infrastructure.

The recommendation to introduce bulk-purchase competitive tendering to drive cost reductions into fee reductions is a sound way to raise returns net of fees. It shows that even in a mature system costs reductions do not get passed on to members unless demand and supply works for them.

The Australian experience shows the necessity for good data on costs and returns so that clear conclusions can be drawn about what is working. In too many countries the basic data does not exist to allow such evidence-based policy – a weakness many systems should rectify.

The Murray Report highlights the central importance of scale and governance in driving good outcomes. It provides an unrivaled way to see the side-by-side comparison of different delivery models. Good trustees or governing boards focused on long run member interest add great value.

Finally, the Murray Review stresses once again the importance of the payout phase – and integrating thinking about it with the accumulation phase. The same issues that exist in the accumulation phase - of demand and supply, of securing best value for members in the context of complex financial issues - are present in just the same way in the decumulation phase.

## INTRODUCTION

This note reviews the key analysis and recommendations from the review of the private pension system in Australia known as the ‘Murray Review’. It provides a commentary on the implications for pension reforms using World Bank experience in a range of projects. The full report is at: [http://fsi.gov.au/files/2014/12/FSI\\_Final\\_Report\\_Consolidated20141210.pdf](http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf)

## SUMMARY OF RECOMMENDATIONS FROM THE MURRAY REVIEW

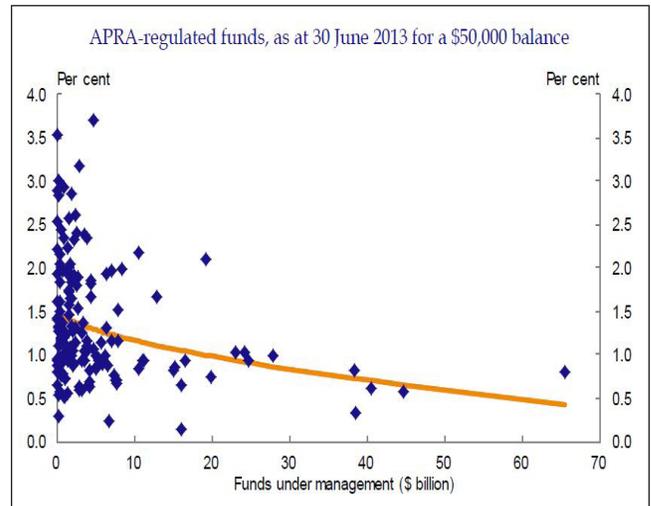
- Have a clear retirement income objective for superannuation and include other key desirable elements such as the system being fully funded, simple, efficient and provide safeguards;
- Introduce an auction or tender to allocate members to a default fund if the ‘Stronger Super’ reforms (that followed the 2010 Cooper Report) do not deliver significant improvements by 2020. All new prices would have to be offered to existing members (as in Peru).
- Require a majority of independent directors on pension fund board to improve governance;
- Improve disclosure and transparency for consumers;
- Restore prohibition on direct borrowing by superannuation funds to ensure they remain unleveraged institutions that contribute to financial stability.

**Lack of efficiency due to lack of price competition was a major driver of the report which highlights** “Substantially higher superannuation balances and fund consolidation over the past decade have not delivered the benefits that would have been expected; these benefits have been offset by higher costs elsewhere in the system rather than being reflected in lower fees” (Murray Report, p119, 2014).

## DETAILS – with a particular focus on market structure, costs and fees

The average size of a superannuation fund has grown significantly since 2004 – from AUSS\$260m to AUSS\$3.3bn in 2013. But the average fees have only fallen by 20 basis points – from 140 basis points to 120 basis point. Analysis for the review suggested a fall of at least 60 basis points – to around 80 basis points would have been expected<sup>1</sup> (within the current market structure). Figure 1 shows there are in general very strong economies of scale as fund size increases in terms of lower fees despite the lack of full pass-through identified above.

Figure 1: Impact of economies of scale on fees in Australian private pensions



Source: Rice Warner.<sup>25</sup> Line of best fit added by Financial System Inquiry..

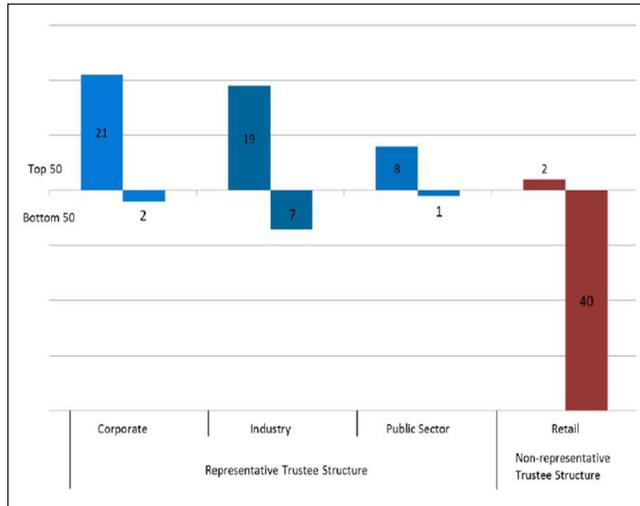
The review also contained very useful information comparing the long run rates of returns from pension funds with different board structures and different profit orientations. The for-profit retail funds consistently perform worse than the different types of not-for-profit funds. The not-for-profit sector includes employer sponsored funds found in many countries such as the UK, US and Canada as well as developing countries. It also includes industry funds as in the Netherlands. Note that not-for-profit effectively describes the long-term objective or orientation of the funds – they can and do contract with the private sector for services. However, their long-run member retirement focus is often what sets them apart.

A key conclusion was that market forces within the for-profit market were not leading to lower costs being passed on to members. This was due to the well-known problems in the lack of an effective demand side in mass market private pension provision<sup>2</sup>. This had a clear impact on net of fee returns. Figure 2 shows the breakdown of the top 50 best performing funds and the bottom 50 worst performing funds over the past 10 years. It shows that overwhelmingly the worst performing funds are concentrated in the for-profit retail sector and the best performing funds are in the not-for-profit sector established for workers in a particular company or industry.

<sup>1</sup> Rice Warner 2014, *Superannuation Fees*, Data provided to the Financial System Inquiry, 23 July 2014.

<sup>2</sup> See for example the discussion at the [6th Global Pension and Saving Conference](#), World Bank April 2014, including [Price \(2014\)](#) and [Impavido and others \(2010\)](#).

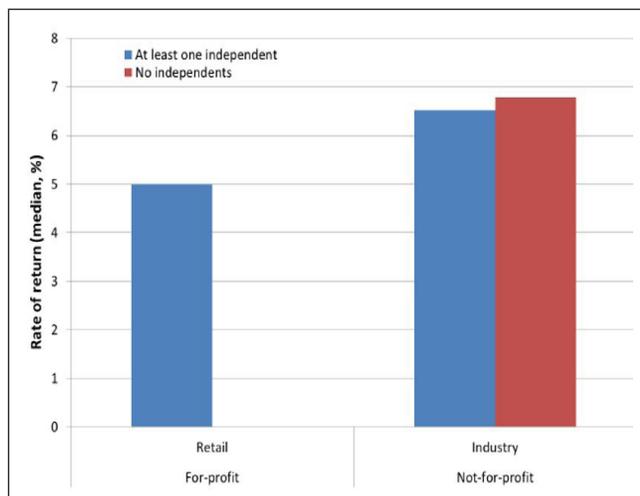
Figure 2: 50 top performing funds vs 50 lowest performing funds based on annual 10 year ROR to June 2013, by fund classification and profit orientation



Source: APRA (2014) Fund-level Rates of Return.

In terms of absolute rates of return over the 10 year period in nominal terms the same message is seen again. The not-for-profit structures outperform the retail for-profit structures by around 150-190 basis points a year on average (1.5% to 1.9% a year). Australia is able to provide these breakdowns because it has been insisting on cost and returns data for many years.

Figure 3: 10 year rate of return, to June 2013, by fund classification and board composition



Source: APRA (2014) Fund-level Rates of Return.

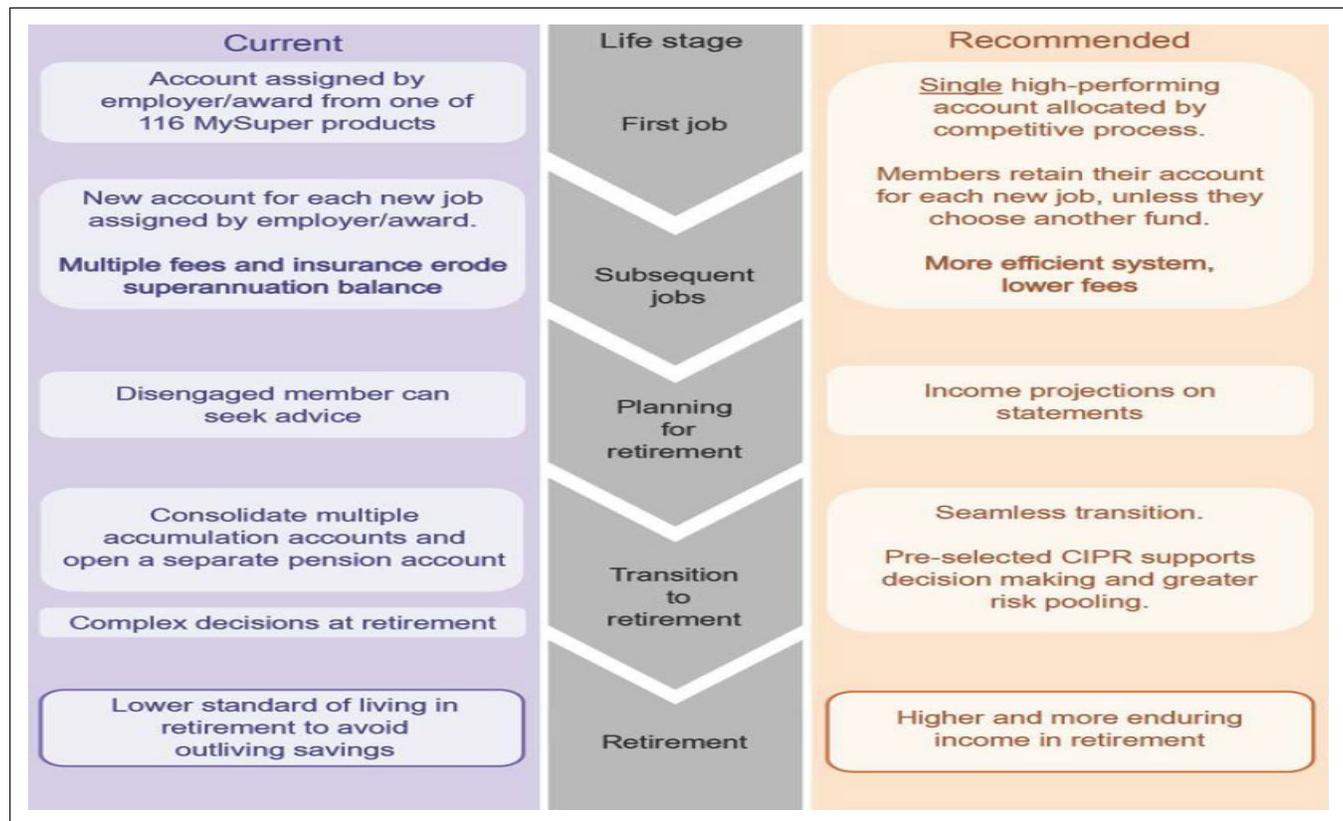
The lack of a single account for each person leading to fragmentation - and lack of bulk purchasing efficiencies passed to members - was identified as a central cause of the problem. The Murray Review highlights how they would change the current disaggregated model. The proposed changes would also reduce the burdens on employers and members to make choices unless they actively wanted to do so. As noted in the conclusions to this note, recent developments in individual ID systems and in IT provide significantly improved options to develop high quality, low cost, individual accounts that can leverage improvements in financial inclusion to offer people in a wide range of countries access to pension and savings accounts that would previously have been impossible.

The most significant recommendation is likely to be the introduction of competitive tendering or auctions to provide the default pension fund for new entrants. The review noted that the Future of Financial Review banned the charging of commissions for the MySuper product – which is expected to reduce costs by 25 basis points, and the ‘Stronger Super’ reforms may also produce benefits and have not fully taken effect. But there is still a difference of 136 basis points, or 1.36% points between the highest and lowest cost MySuper products. So the Murray Review want to go further – subject to a review of outcomes in 2020. The new approach would move away from the model of employers selecting a provider from over 100 MySuper funds – with a new market structure as in Figure 4.

The Murray Review assesses a range of objections to having a competitive process and has set out the counter-arguments. Most of the arguments are simple to rebut – not least because many countries and employer based pension funds have been using competitive tendering for pension services successfully for many years. One problem Australia would have is the lack of a centralized account management system as in Sweden, India and New Zealand. The review notes that this could be created in the future, but its absence does not prevent the benefits of the competitive tendering/auction proposals.

Another major area of reforms is in the payout phase where Australians can currently take all accumulated assets in a lump sum. The Review aims to improve the provision of retirement income. The key recommendation is for each pension fund to have a core long-term retirement income product that it would offer to members. Members could do something different – but the hope is that as with the accumulation phase members would go for the core options. However, this may prove to be optimistic as the short-term attraction of the lump sum option may still prove too tempting.

Figure 4: Improving the market structure and value chain for Australian Pensions



Source: Murray Review, 2014, pp 93.

Table 1: Issues to address to establish a new competitive process in Australia

Potential design issues or concerns	Response or design approach
A formal competitive process is unproven. Furthermore, governments have a poor track record of running formal competitive processes.	Large corporate funds successfully run tenders. A number of other jurisdictions use competitive tendering in pension funds; for example, New Zealand, Chile, and Sweden. Governments around Australia run successful tenders, including the Future Fund, and the Northern Territory Government for its public sector superannuation scheme.
The market disruption would be too great.	The effect on market structure could be gradual, as only new entrants to the workforce would be assigned to funds under the competitive process. By default, existing members would remain in their current fund, thereby minimising market disruption. Unsuccessful funds may have increased switching rates; however, current switching rates are very low. <sup>53</sup> All funds can still compete for choice members.
A Chilean-style auction that selects a single or small number of successful bidders would inhibit competition and innovation, and lead to excessive market concentration.	A significant number of successful funds would be selected, which would drive competition and innovation. Some market consolidation is likely to occur, but excessive market concentration can be avoided if a sufficient number of funds are selected through the competitive process.

## NEW LESSONS FROM AUSTRALIA TO IMPROVE PENSION OUTCOMES

Fees should not be the sole focus. This would result in a ‘race to the bottom’ whereby funds change asset allocation and investment strategies to reduce fees.	The Inquiry agrees with this sentiment and considers a focus solely on fees is not in members’ best interests. As discussed above, the focus should include expected ability to generate high after-fee returns based on asset allocation and investment strategy, as well as past performance.
How will the competitive process lower fund costs?	Competitive pressures will help to keep fund costs down as assets in the system continue to grow. Member acquisition costs will fall as funds do not need to compete for default fund members (outside the tender process). More consolidation of funds and reduced proliferation of multiple accounts across members will better realise the benefits of scale.
Focusing on the default fund market and only targeting new entrants to the workforce is too narrow-focused. It will not address competition and efficiency issues in the broader superannuation system.	Successful funds would be required to offer the same fees and MySuper products to all members (both new and existing). They could not price discriminate across the market. Outcomes in the default market represent a baseline against which choice products could be compared and could be expected to drive greater competition. Transfers to these funds would be facilitated by the recommendations to allow all employees choice of fund (discussed in this chapter) and increase member engagement (see Appendix 1: Significant matters for further detail).
A competitive process would lead to the loss of existing high-performing corporate funds.	Existing corporate funds could be allowed to continue to receive new default fund members from new entrants to the workforce provided the fund gives members comparable benefits to funds successful in the formal competitive process.
Any competitive process can be gamed.	Careful design, rigorous execution and the highest standards of probity and expertise will be required. As mentioned above, other jurisdictions and corporations already run tenders successfully.
Past performance is not an accurate predictor of future performance.	Past performance would be only one element of the selection process when assessing expected ability to generate high after-fee returns to members.
What would stop unsuccessful funds significantly increasing their fees for existing default fund members?	Funds that do this could be disqualified from future competitive processes. Prompts on myGov for individuals to look at a central repository of MySuper dashboards would also help encourage members to engage with superannuation and transfer to the fund that best meets their needs (see Appendix 1: Significant matters for further details).
What if a successful high-performing fund underperforms?	Funds could lose the right to receive new members. Members would be advised if their fund was no longer deemed a successful fund.
A competitive process would impose costs on employers, who would have to make contributions to multiple funds.	While SuperStream will simplify how contributions are made, Government should consider implementing a national ‘payment hub’ or ‘clearing house’ by which employers make superannuation contributions to multiple funds. This concept has been implemented in other countries, including New Zealand and Sweden.

**The core payout product suggestion is to combine some use of drawdown and some longevity protection from a group-annuity product (GSA) or a deferred annuity (DLA).** This mirrors the approach suggested in new proposals by the UK’s NEST provider on how to deal with the UK’s recent switch from an annuity-based system to one with complete freedom of choice. The approach could

provide a bridge for countries where there is no effective annuity market – where an initial drawdown approach can be taken that can allow more time for a well-regulated insurance market to deliver the final part of the retirement income puzzle.

Table 2: Options for Retirement products with drawdown plus longevity protection

	Longevity product (a)	Allocation to longevity product	Draw-down of account-based pension	Allocation to account-based pension
CIPR 1	DLA	23%	Exhaust balance at age 85	77%
CIPR 2	Deferred GSA	17%	Exhaust balance at age 85	83%
CIPR 3	GSA	75%	Minimum rates	25%

(a) Deferred products commence payments at age 35..

## CONCLUSIONS AND COMMENTARY

**The Murray Review continues Australia’s proactive approach of regularly reviewing how to improve a system that already has many strong features.** As seen in a range of countries globally with well-respected systems such as the Netherlands or Chile, there is a need to ensure both solid implementation of changes but also a process of continual renewal every 5 to 10 years to ensure gaps in the system are tackled and the system continues to evolve.

**The first recommendation of the Murray Review is for a clear (and legally binding) statement of what the retirement system is trying to achieve – or in other words greater clarity on the desired retirement income outcomes.** This is a sensible move and mirrors what is happening in a range of World Bank projects - from Turkey to India to Costa Rica - to start with the long-run outcomes and then work backwards to find the best ways to achieve them – and then to tackle systematically the biggest risks to the outcomes. It also mirrors some of the Bank’s recent knowledge management work<sup>3</sup>.

**The Murray Report recommendation to introduce bulk-purchase competitive tendering to drive cost reductions into fee reductions is a sound way to raise returns net of fees. It mirrors a trend globally where growing scale but within multiple vertically integrated providers has failed to improve member outcomes sufficiently.** There are a range of solutions across countries that can have benefits - from the use of sensible price caps to establishing centralized administration – if well designed<sup>4</sup>. Simply capping prices

without dealing with the underlying cost drivers can have unintended negative consequences. The competitive tendering or auction approach can be effective in reducing costs and fees in a mature system – particularly where there is little appetite to re-draw the entire market structure of existing providers. This is not to say that there should always be a not-for-profit or public sector provision model. Rather the key point is that there has to be close attention to what provides the best long-run outcomes – and to ensure that both the demand and supply side of the question is scrutinized closely.

**The Australian experience shows the necessity for good data on costs and returns so that clear conclusions can be drawn about what is working<sup>5</sup>.** In too many countries the basic data does not exist to allow such evidence-based policy. It should be a core feature of any regulatory and supervisory system to insist on the production of accurate cost and returns information, to publish it for transparency and to use it proactively to understand what is working and what can be improved.

**The Murray Report highlights the central importance of scale and governance in driving good outcomes – along with a well-designed ‘market structure’ – the way in which demand and supply come together in the pension market.** These themes will be developed in future Knowledge Notes, for example highlighting the importance of developing efficient collection, record keeping and account management systems as in pension systems as diverse as India’s NPS or in Sweden. The benefits of scale provide a strong argument for building it into the initial design of a pension system – or

<sup>3</sup> See for example Stewart (2014) ‘Proving incentives for long-term investment by pension funds: the use of outcome-based benchmarks’, World Bank Policy Research Working Paper No. 6885 and work by John Ashcroft, William Price and Michael Hafeman ‘Strategy, Risk Based Supervision and Outcomes’, presentation by Michael Hafeman at the 6th Global Pension and Saving Conference.

<sup>4</sup> Future notes will highlight the experience in a range of developed and developing countries that have developed very efficient collection, record keeping and account management systems. These are delivered in different ways – sometime leveraging tax collection as in Sweden, or developing a central record keeping and account management function that can be used by a wide range of providers, as in the NPS in India. Combined with effective Identification these developments offer a unique opportunity to expand pension and saving coverage and to link with modern payment systems to channel small payments across often turbulent work histories in the formal and informal sector.

<sup>5</sup> See the APRA Superannuation Reporting Framework for all reporting requirements including the associated forms, including those on fees at <http://www.apra.gov.au/Super/Pages/Superannuation-reporting-framework.aspx>

improving the operation of existing system, for example as seen in the recent mergers of providers in the Netherlands. The Governance benefits of having not-for-profit trustees including independent directors to focus on the long-run best interests of members will also be examined – in order to highlight the range of options that can then be tailored to a specific country context.

**Finally, the Murray Review stresses once again the importance of the payout phase – and integrating thinking about it with the accumulation phase.** The same issues of demand and supply, of securing best value for members in the context of complex financial issues, that exist in the accumulation phase are present in just the

same way in the decumulation phase. Scale and governance are critical to improve outcomes for members – along with ensuring that there is an option to translate the assets into a stream of income for retirement. Likewise, the right investment strategy needs to explicitly match the nature of the draw-down phase. Without these features, much of the good developments in improving asset accumulation can be dissipated through high charges, inappropriate asset allocations and poorly designed products. These issues too will feature in future knowledge notes – in particular how to deliver retirement income flows at low cost and in environments where annuities are not possible for capital market or policy reasons.



