BEHAVIOURAL
ECONOMICS

From Wallis to Murray: the new consensus

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Industry Super Australia

ABOUT INDUSTRY SUPER AUSTRALIA

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1. Introduction

Since the Wallis Financial System Inquiry in 1997, there has been a seismic shift in thinking about how people interact with the financial system. This shift has profound and positive implications for consumer protection and other aspects of public policy in respect of financial services.

In 1997, consumers were assumed to be rational actors who were able to find and understand all relevant information in order to make an informed financial decision. This led to the view that consumer-driven, disclosure-based competition would drive improved consumer outcomes in financial services as well as superannuation.

However, this has proved not to be the case.

Fast-forward to 2014 and there is a new consensus about how consumers actually behave and how best to protect them. As the Murray Financial System Inquiry Interim Report noted:

> ***"Since the [Global Financial Crisis], the emerging theory of behavioural economics has recognised that most individuals do not always react in a rational way. Behavioural biases can reduce the effectiveness of many traditional consumer protection approaches, which rely on the assumption that consumers will seek out all relevant information before purchasing a financial product."***[1]

The consequences of this new consensus are profound, especially in superannuation. As recently as the 2005 Choice of Fund legislation, superannuation policymakers were acting under the mistaken assumption that consumer-driven competition would deliver optimal outcomes.

The Wallis Inquiry and proponents of Choice of Fund predicted that rational and informed decision-making by individuals would lead to a reduction in fees, and superior scale and risk-adjusted returns.[2] These predictions have not been borne out.

Recognising that people are not rational actors, what does this mean for regulatory policy? In superannuation, it means that consumers tend not to make active choices solely through internal motivation. Instead, they typically act in accordance with "default" settings or make an active choice only under sales pressure. This is why the Murray Inquiry supported a "default fund" safety net that screens out all but the very best super funds, selected on transparent criteria, to better protect the majority of consumers who do not actively choose where to direct their compulsory superannuation contributions.

In addition, the Murray Inquiry recommended that the creators of financial products should bear greater responsibility in ensuring that consumers are well served, including by indicating that certain financial products are not appropriate consumer offerings. Together with the recommendation that ASIC be empowered to ban inappropriate financial products, it is clear the Murray Inquiry has moved toward recognising the reality of how consumers actually behave.

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[1] Financial System Inquiry – Interim Report, 2014

[2] See, e.g., Drew, M.E. and Stanford, J.D. (2003) '*Principal and Agent Problems in Superannuation Funds*', Discussion Paper No. 142, March 2003, Discussion papers in economics, finance and international competitiveness, Queensland University of Technology

Arriving At A New Consensus 1997-2014

- **1997** Wallis Inquiry: super fund members should be treated as rational and informed investors
- **2005** Choice of Fund legislation: rational and informed decision-making by individuals would reduce fees and increase returns
- **2010** Cooper Review: observed that the theory of rational, informed investors differed from reality and makes recommendations based on behavioural economics
- **2012** Productivity Commission: recognises behavioural economics and builds upon the Fair Work Commission selection process of default funds in modern awards
- **2014** Murray Inquiry: recognises behavioural economics and recommends merit-based selection process of default funds beyond modern awards

2. Behavioural economics

2.1 Overview and key findings of the literature

While much of the thinking informing the Wallis Inquiry rested on theory and assumption, behavioural economics is characterised by empirical analysis. Rather than assume people will behave in a certain way, behavioural finance researchers explore how people actually behave. This research has demonstrated that individuals are not rational in their financial decisions. They face a number of barriers:[3]

- **Complexity:** Behavioural economics holds that, in making decisions, the rationality of consumers is bound or limited by a person's ability to process complex issues when making decisions.[4] In superannuation, amid an environment of unstructured choice and hyperactive retailing, individuals must make a series of complex decisions which ultimately will significantly affect their wellbeing in retirement.

- **Choice overload:** Consumers are overloaded with choice. Most consumers don't have the skills to understand their own financial needs, compare literally hundreds of investment options and analyse performance, fees and risk and then match their risk/returns preferences with the optimal product.

- **Low levels of financial literacy and numeracy:** This is a further challenge to decision making, on top of the cognitive factors underlying behavioural finance findings. While desirable, improvements in financial literacy will not deflect the implications of behavioural finance: even sophisticated investors can make serious errors.[5]

- **Framing effects:** Where people make a choice based on how available options relate to one another, how they are explained and what other information is provided at the same time, rather than which

[3] Fear. J, and Pace, G, Choosing not to Choose: Making superannuation work by default and Productivity Commission Inquiry, Default Superannuation Funds in Modern Awards, 2012

[4] Treversky, A, and Kahneman, D, 1991 and Treversky, D, 1974

[5] See, e.g., Tversky, A., and Kahneman, D, *Judgment Under Uncertainty: Heuristics and Biases*, Cambridge University Press, Cambridge UK, 1991 (finding optimism bias in estimating knowledge certainty common to both sophisticated and naïve subjects); Tversky, A. 'Assessing Uncertainty', *Journal of the Royal Statistical Society*, (finding professional researchers demonstrated erroneous belief in the law of small numbers)

option is in their best interests. Product providers and sales personnel typically shape the frame through which consumer choices are made.

- **Procrastination**: Also known as 'status quo bias', this is an extremely common behavioural trait in financial decision making.[6] One in three Australians 'often put off financial decisions until later' and consolidating multiple superannuation accounts is one of the most common examples of this, often due to simple barriers such as filling in a form.[7]
    - In the context of retirement planning, status quo procrastination over a person's lifetime can result in significant losses because they fail to take advantage of better options.
- **The endowment effect:** This is the tendency for individuals to value money that is lost more than money that is gained, resulting in excessive conservatism in investment and other decisions which can result in significant foregone investment returns over a person's life.
- **Opaque pricing and information asymmetries**: There may be a lack of transparency as to the real costs of a product. This is just one of the asymmetries between individuals and product providers.
- **High search costs**: In addition to overwhelming the individual, complexity can result in high search costs. This is compounded by the frequent change in superannuation policy and a lack of confidence that financial advice is in an individual's best interest.
- **Mental rules or short cuts** (heuristics): Used by people where they have no clear preference or where the cost of acquiring information is too high. This can lead to persistent biases in decision making.

Research into the phenomenon of choice overload indicates that when it comes to choosing a fund, individuals actually prefer fewer choices[8] and tend to focus on returns and ignore risks and fees.[9] This is a strong argument in favour of the default fund safety net to guide superannuation contributions towards a high performing fund.

If the market were already operating efficiently, there would be evidence that super fund members do indeed respond to relative prices and performance by shifting from consistently poorly performing funds to consistently well performing funds. However, there is limited switching in response to poor fund performance (and limited but poorly timed post-facto switching within funds, particularly in response to downward market movements).

Since Choice of Fund became effective in July 2005, the percentage of members switching funds in any given year has hovered around 3 per cent,[10] and cumulatively less than 15 per cent of members had switched funds in the first 5 years of Choice of Fund after adjusting for the creation of multiple accounts.[11, 12]

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[6] Samuelson. W, and Zekhauser. R, Status Quo Bias in Decision Making, *Journal of Risk and Uncertainty*, 1988

[7] Fear. J, Choice Overload: *Australians Coping with Financial Decisions*, The Australia Institute, Discussion Paper 99, 2008

[8] Iyengar, S. S, and Lepper, M. R, 'When Choice is Demotivating: Can one Desire too Much of a Good Thing?', *Journal of Personality and Social Psychology*, 79(6), 995, 2000

[9] Harless, D. W, and Peterson, S. P, 'Investor behaviour and the Persistence of Poorly-performing Mutual Funds', *Journal of Economic Behavior and Organization*, 37(3), 1998

[10] Industry Super Network, *Supernomics: Addressing Failures of Competition in the Superannuation Market*, 2010. See also, Roy Morgan Research, *On the money: Australians' changing attitudes to wealth, debt, superannuation and plans for their financial future*, 28 November 2013 (observing that 3.4% of members switched in the financial year 2013, down from 4.9% in 2012).

[11] Id.

While there is a lack of evidence that competition generally has led to lower costs or better performance, there is evidence that product providers do compete on other product features. This has further increased product complexity over time, further complicating consumer choice.

This pattern of competing via product differentiation, not price, is consistent with oligopolistic competition.

2.2 Adoption of these concepts in the Murray Inquiry

As noted in the introduction, the Murray Inquiry recognised key aspects of behavioural economics. It differentiated Australia's super system from a "traditional competitive market" due to compulsion, complexity, weak member-driven competition and agency issues on the part of employers which were also found to be ineffective at driving competition in the default market.[13] Accordingly, the Murray Inquiry supported a default fund safety net that screens out all but the best funds based on transparent criteria, believing this is required to protect people who do not choose where to invest their superannuation contributions.

Furthermore, the Murray Inquiry conceded that the current, but not yet fully implemented Fair Work Commission process which emerged from the Productivity Commission Inquiry should be able to run its course. For workers not covered by modern awards, the Murray Inquiry expressed scepticism about the ability of recent MySuper reforms to achieve policy goals, and recommended a further Productivity Commission review in 2020 to determine whether the competition and efficiency of the superannuation system is adequate and, if not, introduce a formal competitive selection process to determine which products are of sufficient quality to serve as a default fund, and to allocate new workforce entrants these products.

In making this recommendation, the Murray Inquiry rejected the idea that employers should be able to choose any MySuper product as the workplace default fund as a way to increase competition and reduce compliance costs. This would leave closed a potential channel through which banks could leverage their banking relationship with the employer to secure employee super contributions into what may be sub-optimal products.

The Murray Inquiry agreed with the Productivity Commission view that a 'quality filter' is needed and that the MySuper system is unlikely to act as an effective filter, even with reform. The Murray Inquiry concurred with the Productivity Commission view that: ***"The Stronger Super reforms serve largely to …improve comparability… rather than filter out any products which may not represent the best interest of members."***

The Inquiry also recommended:

"Criteria for selecting successful funds should focus on expected after-fee returns based on asset allocation and investment strategy, fees and past performance. This would help avoid fee reductions at the expense of member returns. Any other requirements deemed necessary could be included in pre-set selection criteria to participate in the process."

The Murray Inquiry concluded that the principles for designing any selection process should give priority to:

- Members' best interests: ensuring incentive compatibility with meeting the best interest of members, encouraging long-term investing, discouraging excessive risk taking and encouraging a focus on after-fee returns.

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[12] It is important to note that switching is can be the result of changes in employer, which means that switching is not strictly equivalent to choosing.

[13] FSI 105-106

- Competition: driving pressure on funds to be innovative and efficient, diversify asset allocation and maximise long-term net returns by rewarding best performers.
- Feasibility: ensuring the process is low cost and easy to administer and minimises the regulatory costs on industry.
- Credibility and transparency: making relevant information public; shut down gaming of the process; ensuring metrics are clear, simple and difficult to dispute and manipulate.
- Regular assessment and accountability: making relevant information public. Through a regular selection process, default funds would be required to earn their right to receive new members, and ensure funds are accountable for the outcomes they deliver members.

Besides the default fund safety net, behavioural economics informed other recommendations in the Murray Inquiry. Recognising how reliant consumers are on product providers, the Inquiry also recommended that issuers and distributors of financial products should be held more accountable for the design and distribution of their products noting ***"this should strengthen consumer confidence and trust in the system and reduce the number of cases where consumer behavioural biases and information imbalances are disregarded."***

In the same vein, the Inquiry made a further recommendation to provide ASIC with product intervention powers to enable it to intervene without a demonstrated or suspected breach of the law. The power would allow ASIC to require or impose (i) amendments to marketing and disclosure materials, (ii) warnings to consumers, and labelling and terminology changes, (iii) distribution restrictions and (iv) product banning.

2.3 Productivity Commission Inquiry

Following the 2010 Cooper Review into the superannuation system, the federal government asked the Productivity Commission to define criteria for the selection and ongoing assessment of superannuation funds eligible for nomination as default funds in modern awards by the Fair Work Commission. From the outset of the Productivity Commission's report, the thinking was clearly informed by behavioural economics:

> ***"Despite the growth of superannuation in Australia most employees do not make an active choice about which fund and/or which product in that fund their superannuation contributions should be paid into. This can be due to a range of reasons, such as the complexity of decisions and apathy about superannuation given its compulsory nature. The failure of many employees to make an active choice is the primary rationale for having a default fund system."***

The Productivity Commission examined the default fund selection process and observed that it had delivered good outcomes to members. Default funds listed in awards over the eight years to 2011 averaged a 6.4 per cent return per annum after taxes and fees compared to 5.5 per cent for funds not listed in awards.

Updated data shows that the industry super funds listed in awards have achieved an average return over 10 years of 7.32 per cent per year, which is 205 basis points above the average return of retail funds listed in awards.

The Productivity Commission determined that a default fund quality filter was required for two key reasons:

- The earlier Stronger Super reforms served to standardise features and promote disclosure to improve comparability between MySuper products, rather than filter out any products which may not have been in the best interests of employees. In other words, the Productivity Commission was not satisfied that the MySuper authorisation process was a sufficient filter to ensure the best interests of employees.
- The Productivity Commission concluded that shifting the onus for the selection of default super products directly to employers would risk misalignment of interests and involve unacceptable compliance costs for

employers in determining the suitability of funds for their employees.[14] The legal, compliance and administrative burden of listing all MySuper products in awards (which would have the same practical effect of listing no funds) would be substantial.

The Productivity Commission recommended a number of key changes to the default fund selection process including:

- Requiring all funds seeking listing in awards to make public applications against key selection criteria including:
  - The appropriateness of the MySuper product's long-term investment return target and risk profile for employees who derive their default superannuation product in accordance with a given modern award.
  - The fund's expected ability to deliver on the MySuper product's long-term investment return target, given its risk profile.

The Productivity Commission considered net investment performance central to meeting the best interests of members and past performance an important factor when considering the capacity of a fund to deliver on its return target

2.4 Cooper Review

The 2010 review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System – known as the Cooper Review – was a ground-breaking review. Preceding the Murray Inquiry and the Productivity Commission review of default funds in modern awards, the Cooper Review expressly incorporated behavioural economics into its consideration of the superannuation system.

The Cooper Review observed that:

"[i]n classical economic theory, markets efficiently allocate resources, shape products, and determine prices. In superannuation, competition in the market for super at the consumer level (ie between funds competing for the business of a new member) has so far been relatively weak. This is because superannuation is different."

The review went on to identify a range of differences between ***"the theory of rational and informed investors versus real life experience,"*** and produced recommendations based on a framework that ***"is an adaptation of contemporary thinking in the field of behavioural economics."***

The Cooper Review approach to consumer protection relied on restricting eligibility to act as a default fund to highly regulated superannuation products labelled "MySuper" products. This eligibility restriction would apply to (i) default funds for employees not covered by modern awards, and (ii) be a threshold condition for default funds selected in modern awards.

With respect to default funds selected in modern awards, the Cooper Review recommendation contemplated that this selection process would continue to be conducted by the industrial umpire.

[14] Productivity Commission, *Review of Selection of Default Funds in Modern Awards* p 190 and box 8.1 p 171

The emerging consensus on default super arrangements

Hand-in-hand with the shift in the policy consensus away from the idea of rational and informed investors has been an emerging consensus on how to regulate superannuation consistent with the realities of behavioural economics.

Over the past five years there have been three separate reviews of superannuation that have considered default super arrangements. Each has:

- recognised the need to accommodate the reality that the majority of Australians do not choose their own super fund;
- determined that a selection process or 'quality filter' is necessary; and
- recommended the retention or the strengthening of the selection process of default funds in modern awards by the Fair Work Commission and retained the Fair Work Commission as the appropriate venue for the selection process.

The bank-owned super funds are the sole opponents to the consensus position reached by these three government inquiries.

The emerging consensus about default super arrangements demonstrates an evolution in thinking as the superannuation system has matured. The 2010 Cooper Review focused primarily on product-level regulations, rather than the process by which default funds are selected, stating that:

"There seems to be no reason why the default funds in modern awards should not continue for the time being. They are due for comprehensive review in 2014. In order to prepare for the 2014 review, the Panel considers that, in 2012, the Productivity Commission should examine the way default (MySuper) funds are nominated under the awards system, with a focus on whether the procedures are the most open, transparent and competitive means by which members are given access to the most favourable default (MySuper) offerings."

The then Government adopted the Cooper Review's recommendation and tasked the Productivity Commission with reviewing the way default funds are determined under the award system. This 2012 review found that workers required a merit-based selection process as a 'quality filter', beyond mere MySuper licensing:

"The Stronger Super and related reforms provide an effective foundation to promote disclosure and comparability of default superannuation products and funds but, given the uncertainty surrounding the likely number, mix and quality of MySuper products, there needs to be a 'quality filter' to distinguish among them. …A Default Superannuation Panel should be established within Fair Work Australia to make decisions about which products are listed in awards. …The number of default products listed in a given modern award should be at the discretion of the Default Superannuation Panel."

The 2014 Financial System Inquiry also supported the establishment of a quality filter based within a selection process for default funds, and expressly supported the Productivity Commission recommendations. The Inquiry rejected the lobbying of the bank-owned super funds to remove the default fund selection process:

"The [bank-owned funds' proposal] involves abolishing the new Fair Work Commission (FWC) process for selecting default funds in awards and allowing all MySuper products to be listed in awards. Under this alternative, employers could select any MySuper product to satisfy the requirements under an award. The Inquiry believes that this alternative would only be effective if there were an alternative quality filter for default fund selection. The [Productivity Commission]'s inquiry into default funds in awards found that a 'quality filter' is needed, stating: 'The Stronger Super reforms serve largely to standardise features and promote disclosure to improve comparability between MySuper products, rather than filter out any products which may not represent the best interests of employees.' The [Productivity Commission] made a number of recommendations to improve the effectiveness of this filter, which the Inquiry supports and which are still to be implemented by Government."

These reviews provide a clear consensus that, where members do not choose a super fund, someone else must choose. These inquiries have concluded that a selection process run by the Fair Work Commission works well. The 2014 Financial System Inquiry sought to extend the protection of a merit-based selection process beyond the modern award system, to all super fund members. The empirical evidence clearly shows that if all Australians had a super fund equalling the performance of the average super fund selected by the Fair Work Commission process, they would collectively have billions of dollars more in retirement savings.

3. Conclusion

The Murray Inquiry, the Productivity Commission Inquiry and Cooper Review each represent significant milestones in terms of embracing the thinking of behavioural economics and what it has to say about individuals' interaction with the financial system. In short, people do not behave rationally, as the 1997 Wallis Inquiry believed.

Moreover, one of the critical areas where the real world departs significantly from the Wallis Inquiry assumptions is in relation to saving and investing for retirement, which ticks all the boxes of behavioural economics: the decisions are complex, the costs and benefits emerge over longer periods of time and the information necessary to make the best decisions is often unavailable or costly to obtain.

Efforts to deploy consumer-driven competitive market forces in superannuation, grounded in Wallis Inquiry thinking, have led to perverse outcomes: workers whose superannuation contributions were placed in workplace default fund have achieved better performance on average over the longer term than workers who made active choices about where to place these contributions, or were sold retail super funds by financial advisers.

Despite these perverse outcomes, financial institutions continue to call for deregulation of default fund selection to increase so-called 'competition'.

Three independent reviews, commissioned by two separate governments have now concluded that consumers need the protection of a default fund safety net. The Productivity Commission and Murray Inquiries have both rejected calls for deregulation of default fund selection and concluded that members of workplace default funds need strong protections that competitive market forces could not reasonably be expected to provide. Both build on the Cooper Review's recommendations which also envisaged a continued role for default funds in awards approved by the industrial umpire.

It will take time for the implications of behavioural economics to be fully recognised by all policymakers and even longer to be translated into sound policy, replacing a deeply embedded assumption that consumer behaviour is rational. This is particularly so where these new ideas conflict with existing business models and threaten the short term pecuniary interests of financial institutions. However, there is no doubt that the Cooper Review, Productivity Commission and Murray Inquiries have moved the policy debate in the right direction.