Thought Pieces with The Conexus Institute

Ensuring all retirees find a suitable retirement solution

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Introduction[1]

The Government is currently drafting the Retirement Income Covenant (RIC), which is expected to come into operation on 1 July 2022. The RIC will "codify the requirements and obligations of superannuation trustees to improve the retirement outcomes for individuals".[2] This paper outlines what is needed to establish a retirement framework that ensures super funds assist *all* retiring members to find their way to retirement solutions that are not only suitable for their needs, but also accord with how they want to engage with the process.

Our central theme is the need to cater for substantial differences in the willingness and capacity to make financial decisions, and to seek financial advice. We argue that reliance should not be placed entirely on retirees to actively choose a retirement solution for themselves. The ability for retirees to request that their super fund either recommend or select an option on their behalf should be accommodated, which we call 'fund-guided choice'.[3] A mechanism is also needed to

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[2] RIC Position Paper, Treasury (2021, page 2). See: https://treasury.gov.au/consultation/c2021-188347.
[3] The expression 'guided choice' was also used by the Retirement Income Review (RIR, 2020) to describe much the same thing (see pages 454-458).

address fund members who do not choose at all, which might entail a 'safety net' provision whereby trustees can assign retirees to an option under certain conditions.

Our focus is the delivery mechanisms for suitable retirement solutions by APRA-regulated funds. We do not let the existing legal and regulatory environment nor policy guidance constrain our considerations, although do attempt to identify where our recommended mechanisms sit outside existing and indicative constraints. We also offer suggestions on how the RIC might be framed to accommodate differences across member types in their preferred mode of engagement.

Where we currently seem to be heading

The RIC will establish the principles under which super funds provide retirement solutions, which might be seen as comprising a joint drawdown and investment strategy involving one or a combination of products. The fact that accumulated savings of retirees are stapled to a super fund under the *Your Future, Your Super* legislation makes it more likely that super funds will be the dominant provider of retirement solutions and services to their retiring members, at least initially. The Government has indicated a strong emphasis on consumers making an active choice, which is confirmed by the RIC Position Paper (Treasury, 2021). A substantially choice-based architecture in retirement would be quite different from that in accumulation. Diagram 1 outlines what such a system might look like, based on current indications from Government representatives.

Figure 1: Indicated choice architecture for accumulation and retirement.

	Accumulation	**Retirement**	**Assistance**
Within member's 'stapled' fund	1) MySuper default	1) Role of defaults?	
	2) Choice of investment option	2) Choice of retirement option	• Information • Guidance / tools • Advice offered by fund
External choice	3a) Choice of fund 3b) Choice of investment option	3) Choice from large range of retirement products	• Information • Guidance / tools • Advice by financial planners

Note: This diagram accounts for indicated changes under the RIC and stapling as introduced under Your Future, Your Super.

The choice architecture outlined in Diagram 1 generates some observations worthy of further reflection. Default settings have an important role during accumulation: we estimate that 59.4% of accumulation assets in APRA-regulated fund are invested in MySuper options.[4] However, there has been no mention of comparable arrangements in retirement, with the RIC Position Paper making only indirect references to defaults. This implies that default members during accumulation will need to become active choice-makers once they enter retirement. Under such a choice-based architecture, the ability of consumers to compare retirement products and access the necessary assistance to make an informed decision will become even more critical. The

[4] Based on the APRA (2021). Note that this statistic probably understates the degree of choice, as it does not capture choice of fund or active selection of the MySuper option. We thank Aaron Minney for assistance with this calculation.

potential dissonance in choice architecture between accumulation and retirement runs the risk of exposing many retirees to a complex decision problem that they are not well-equipped to make.

The wide spectrum of retirees

Retirees vary along many dimensions. Many of these dimensions relate to solution design and member cohorting, including their financial situation (financial means, home ownership, single or partnered), and personal preferences (such as desired income and ability to tolerate risk). Many of these dimensions are mentioned in the RIC Position Paper. Catering for these differences requires a variety of retirement solutions, which will itself present a challenge for superannuation funds and other providers.

However, there is another important dimension that needs to be considered: the willingness and capacity to engage.[5] This gives rise to an arguably even greater challenge: *how to help retirees find their way to a suitable retirement solution*. This is no simple matter under a largely choice-based architecture. Retirees need to address a complex multi-dimensional problem. They are likely to have access to multiple products that many will not fully understand. The problem is only compounded by large differences in the capability to make financial decisions or preparedness to seek and pay for financial advice. Diagram 2 recognises these differences by presenting a spectrum of retiree types based on the mode they might prefer when engaging with their fund in identifying a retirement solution. We also note the decision frame implied for each type.

Figure 2: Retirement solution choice – A spectrum

Type	**Preferred mode**	**Decision frame**	**Who would identify an appropriate solution**
1. Fully-advised	Seeks comprehensive financial advice	Fully-advised	Adviser
2. DIY-active	Wants to choose by themselves, perhaps with some assistance	Self-directed choice	Retiree
3. DIY-reactive	Would welcome a recommendation from their fund, but wants to decide for themselves	Fund-guided choice	Fund and Retiree
4. Guided	Would prefer their fund to choose an option		Fund
5. Disengaged	Does not engage at all	Fund selection	Fund

Some implications for how a super fund might cater for each type of retiree are discussed below. Our comments allude to various desirable features and delivery hurdles, while recognising that adjustments to the legal and regulatory framework may be required to overcome some of these hurdles. These may be viewed as suggestions that policy makers might want to consider.

1. Fully-advised *– Seeks comprehensive financial advice.* Some retirees will be willing to engage with, and pay for, comprehensive financial advice. This might be provided by the super fund or outsourced to external financial planners. This decision frame is currently challenged on three fronts. The first is capacity to service retirees *en masse*. Adviser numbers have fallen significantly,

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[5] Research identifies different groups of super fund members by willingness to engage. Deetlefs et al. (2019) form five groups based on trust in their fund and revealed interest in their super. A survey by Super Consumers (2021) identifies three groups denoted 'disengaged', 'engaged delegators' and 'engaged DIY'.

and it might be some time before they recover. Second, comprehensive advice is time-consuming and hence expensive to deliver. Many retirees might be unwilling to pay the $3,000-$4,000 it reputedly costs for a full statement of advice, and cost-effectiveness is problematic for those with low assets. Third is the complexity of retirement. The use of stochastic tools to assess retirement risk and address these risks using a variety of different products is not mainstream practice among the advice community. While digital solutions (e.g. robo-advice) might ultimately address some of these issues by increasing capacity and reducing cost, fully digitized comprehensive advice is a future rather than a present reality.

2. DIY-active – *Wants to choose by themselves, perhaps with some assistance.* A self-directed retiree is dependent on a combination of financial literacy and access to appropriate decision support to help them assess the range of possible retirement outcomes and design their own solution by selecting or combining available products. There are several hurdles to the effectiveness of this decision frame. Most important is the capability of retirees to make informed decisions, which we discuss further below. Another is the rules around delivery of financial advice, which arguably need to be (re)framed to remove the barriers around providing retirees with the support they need (even accounting for scope to offer single issue advice). Finally, the required tools need to be made more widely available to consumers. Digital tools (e.g. interactive calculators) would help, although retirees would still be left to interpret the output by themselves. While provision of decision support tools and services may form part of a super fund's retirement strategy, provision may also come from other financial service providers or even the Government (e.g. through ASIC MoneySmart).

3. DIY-reactive – *Would welcome a recommendation from their fund, but wants to decide for themselves.* Some retirees might prefer a recommendation from their fund, which they can then either accept or decide to look elsewhere (thus transitioning to 'DIY-active'). This decision frame aligns with the framework suggested for Comprehensive Income Products for Retirement (CIPRs) by the Financial System Inquiry (FSI, 2014).[6] The provision of product and other information along with tools such as interactive calculators could assist these retirees to gain comfort that the recommended solution is suitable for their needs. This decision frame might be accommodated by super funds applying a cohort segmentation approach to their membership, and developing cohort-based 'tailored defaults'. The recommendation might be presented as designed for the cohort that appears to be the best match for the retiring member, coupled with highlighting the availability of other options, tools and financial advice.[7,8] Again, the rules around the delivery of financial advice may need to be changed in order to facilitate this decision frame.

4. Guided – *Would prefer their fund to choose an option.* We anticipate there might be some retirees who have no appetite to choose for themselves due to a lack of understanding of even the most basic financial concepts. Such retirees might be willing to make an explicit choice to out-source the selection of their retirement solution to their fund. The choice mechanism to

[6] In development of the initially proposed framework, a limited degree of member fact-finding was considered to facilitate CIPR customisation, which was to occur under a safe harbour arrangement. For details, see Discussion Paper (2016) at https://consult.treasury.gov.au/retirement-income-policy-division/comprehensive-income-products-for-retirement/.
[7] For example, the fund might say something like: "We have three retirement income options tailored for 'representative members' Bill, Jane and Sue. The representative member most like yourself is Sue, so the option that we tailored for her is more likely to be suitable for you. We recommend that you should choose that option. If you do not view yourself as similar to Sue, we invite you to consider other options or take financial advice. We can also provide a range of information and tools to assist you with your decision."
[8] Warren (2021) outlines a process of this type.

accommodate this situation could be a variation on that discussed above for 'DIY-reactive', with the exception that the retiree could be asked to sign-off on the solution they are provided.[9]

5. Disengaged *– Does not engage at all.* There has been minimal focus on the possibility that there could be a class of members that might not engage at all. How totally disengaged retirees may be addressed under the retirement choice architecture is unclear. Nevertheless, the retirement framework would be incomplete if it failed to cater for these members. This might be done by placing obligations on trustees to address retirement-age members who do not make a choice. Trustees might at least be required to attempt to engage with these members, and potentially be given the power to assign them to a solution without their prior consent under certain conditions. We discuss the issues surrounding this decision frame in more detail further below.

Why accommodate fund-guided choice

There are three reasons why it would be worthwhile to accommodate the fund either recommending a solution to a retiree, or choosing one on their behalf:

1. Some retirees might prefer it
2. Their fund might come up with a better choice in some situations
3. It accommodates nudges

The idea of fund-guided choice accords with the concept of libertarian paternalism (Thaler and Sunstein, 2003). It also accords with the suggestions of the FSI (2014) and the Productivity Commission (PC, 2018), both of which proposed putting forward recommendations to fund members in order to overcome behavioural biases and other hurdles to effective decisions.[10]

1. Some might prefer their fund to choose

The idea that some people just want someone to choose for them not only seems intuitive, but has evidence to support it. Findings from a number of studies[11] are consistent with many super fund members being willing to trust their fund; and many embracing the default option not because they are disengaged, but because trust coincides with lack of self-confidence to make financial decisions. These studies also provide evidence that defaulting behaviour can coincide with broader signs of engagement. There is a strong hint in this research that many retirees are looking towards their fund for guidance, in particular those who are daunted by making financial choices. The fact that decumulation is a more complex problem than accumulation might further fuel apprehension over selecting a retirement solution. Retirees who feel like this might welcome an opportunity to ask their fund to either assign them to an option or be presented with a recommendation, rather than being forced to choose for themselves, or seek out and pay for financial advice. Remember that some retirees might not possess even the basic skills required to use online tools or interpret intra-fund advice, let alone understand a Product Disclosure Statement. A fund-guided choice option might come as a relief for such individuals.

2. Fund-guided choice might (sometimes) provide better outcomes

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[9] This might happen in lieu of highlighting the availability of further options and decision support.
[10] For instance, FSI (2014, page 91) said the following about CIPRs: "Pre-selected options have been demonstrated to influence behaviour but do not limit personal choice and freedom. They would bring the policy philosophy at retirement closer to that of the accumulation phase."
[11] See Bateman et al. (2014), Butt et al. (2018) and Deetlefs et al. (2019).

Fund-guided choice might lead to better outcomes in some situations, specifically for many retirees who are not willing or able to take comprehensive financial advice. A majority of people have quite low financial literacy.[12] Added to this are the findings of behavioural research that suggest people can make poor choices,[13] especially when faced with complexity and choice overload.[14] In these situations, they might resort to making decisions based on simple rules of thumb or 'heuristics'. They can be influenced by biases related to information availability and framing effects, or follow uninformed recommendations from friends, family or social media.[15] People tend to suffer from myopia, and might struggle to account appropriately for the retirement time horizon or the compounding of returns over that horizon. Some might become prey to unscrupulous providers and marketing puff. Status quo bias and inertia can also play a role, as well as cognitive decline as people age. Further, people can struggle with interpreting financial disclosures, as ASIC (2019) points out. The Productivity Commission (see PC, 2018) placed particular emphasis on behavioral effects under choice as lessening the efficiency and competitiveness of the superannuation system.

Signs exist that the type of influences described above are at play. A vast majority of retirees (83%[16]) invest in account-based pensions and follow the minimum drawdown rules, which they appear to anchor on.[17] It is entirely possible that many retirees do so as these options are presented most clearly to them, and are taken as a recommendation. The Retirement Income Review (RIR, 2020) discusses how these features are contributing to inefficient use of retirement savings, serving as a warning of how choice does not necessarily generate the best outcomes.

Whether fund-guided choice would provide better outcomes than retirees choosing for themselves is difficult to assess. On one hand, only the retiree fully knows their own personal circumstances. Funds will not have complete information on their members, and could assign retirees to options built for broad cohorts that might not be entirely suitable. On the other hand, funds could have better capability to determine what is the best option relative to a retiring member who makes poor choices under the influence of low financial literacy and behavioural hurdles. Offering retirees the option to have their fund either recommend or choose an option on their behalf, ideally accompanied by well-presented information and interactive calculators, would allow people to balance these considerations. They can then decide if they are more comfortable with either choosing for themselves, or accepting what their fund recommends.

3. Fund-guided choice can accommodate nudges

Fund-guided choice can have the spin-off benefit of providing scope for nudges[18] to be introduced into the decision process that could lead to better outcomes for retirees. Both FSI (2014) and PC (2018) explicitly suggested putting recommendations to retiring members for this reason. Innovative and beneficial solutions run the risk of receiving minimal take-up in a member choice environment if they fail to get traction with individuals or their advisers. Meanwhile, it is well known that default settings are very influential.[19] Fund-guided choice could help support a broader take-up of beneficial solutions by presenting them as fund recommendations or offerings, thus positioning these solutions as a baseline that retirees might be predisposed to

[12] For example, see Agnew, Bateman and Thorp (2013).
[13] Authors that discuss behavioural effects in a retirement savings context include Mitchell and Utkus (2006) and Benartzi and Thaler (2007).
[14] These issues are addressed in Section 5A of RIR (2020).
[15] Hirshleifer (2020) discusses social transmission bias.
[16] RIR (2020), see page 439.
[17] Discussed in Section 5A of RIR (2020), see page 445.
[18] See Thaler and Sunstein (2009)
[19] See Beshears et al. (2009) and Bateman et al. (2017).

follow. An example of the power of such mechanisms to drive change was including the scope to offer life-cycle options under the MySuper framework. While life-cycle products were previously available in Australia, the introduction of MySuper resulted in 35% of default assets[20] being invested using a life-cycle approach.[21]

Three specific choices are currently being made by many retirees that arguably limit the amount of value they extract from their retirement savings: minimal take-up of longevity insurance, lack of willingness to draw down on savings to the extent affordable, and investing too conservatively. Addressing these issues should allow retirees to enjoy higher income for longer into retirement. Fund-guided choice could assist by offering the member a solution that embeds a suitable mix of longevity insurance, higher drawdowns and growth asset exposure. This could establish a more appropriate point of departure for those retirees who opt for a form of fund-guided choice, from which they might deviate if they so wish.

A safety net required for retirees who do not choose

Our fifth disengaged retiree type are those who take no action once they reach retirement, either because they are totally disengaged, suffer from inertia or are simply too confused. It is hard to gauge how large this cohort might be. However, it is worth noting that there is $175 billion related to 1.2 million member accounts[22] invested in superannuation funds by those of age 65 and over that remains in the accumulation phase. While there are a number of potential explanations,[23] there is a hint that a significant number of retirees might not have transferred their superannuation balance to the retirement phase due to lack of knowledge or apathy, and might be missing out on retirement income as well as paying unnecessary tax. While the spirit of the Government's retirement income policy appears to be that retirees always exercise some form of choice, we are concerned about outcomes for the heavily disengaged. The alternative of leaving them in the accumulation phase and possibly wholly unsuitable solutions needs to be avoided if at all possible. The next section provides suggestions for creating a safety net for this retiree type.

Implications for the retirement system framework

We argue that the retirement framework should cater for all the types of members highlighted above, and the associated decision frames. Informed member choice, ideally supported by financial advice, should be seen as the gold standard. Unfortunately, financial literacy is too low and comprehensive advice too costly and capacity constrained for a system based on self-directed and fully-advised choice to operate effectively for all retirees. Rather than relying on these two frames, the boundaries of choice should be expanded to permit retiring members to opt for a form of fund-guided choice. There should also be mechanisms to address retirees who do not engage at all. We now put forward suggestions for how this might occur through placing certain

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[20] See Chant, Manokumar and Warren (2014).
[21] We do not comment on the efficacy of life-cycle products here, but merely illustrate the power of defaults.
[22] This estimate arises by comparing Tables 7c and 8a in the APRA Annual Superannuation Bulletin, (APRA, 2021).
[23] Potential explanations include: some members still working beyond 65; accounts over the $1.7 million cap; deliberate decisions to retain the funds in retirement to avoid drawdown; as well as lack of knowledge or apathy. (We thank Jeremy Cooper for suggesting this list.)

obligations on trustees under the RIC. Our suggestions are formed on the basis that the policy intention is for individual choice to sit at the foundation of the retirement system.

Fund-guided choice might be facilitated by placing an obligation on trustees under the RIC to engage with retiring members[24] to ascertain their preferred mode under which a suitable retirement solution is identified, and to accommodate their wishes accordingly. Figure 3 provides an indication of how the engagement process might be initiated by the fund through asking members to make a simple election at retirement. An election of the fund-guided choice options of A or B might then be followed by an invitation to furnish the fund with additional information to assist in making the selection of a suitable solution.

Figure 3: Choices put to a retiring member by their fund

Please choose one of the following options:	
A. Please assign me to a retirement solution	○
B. Recommend a retirement solution to me	○
C. I want to choose a retirement solution for myself	○
D. Please refer me to a financial planner	○

Note: A prior step would establish the balance that the member wishes to transfer into a retirement solution with their fund

For members who fail to respond (i.e. 'disengaged' member type 5), there could be a further requirement to constantly attempt engagement to establish their retirement status and preferences. Those ultimately confirming their retired status could then choose their decision frame, including potentially outsourcing the choice of retirement option to the fund (i.e. request to be treated as 'guided' member type 4). No compulsory retirement default mechanism would be imposed under this approach. However, it could leave the accounts of some retired members in the accumulation phase.

The most effective way of ensuring that totally disengaged members are assigned to a retirement solution would be to empower trustees to default members into a retirement option[25] under certain conditions. A policy solution might be to legislate automatic transfer (say, at age 65) into a retirement account, with the ability for members to opt-out. The main challenge would be specifying the conditions under which an assignment can be made. One major hurdle is that the trustee would need a way of ensuring that the member is indeed retired, and be confident that transferring their balance into the retirement phase is in their best interests. There are also a range of operational challenges (e.g. bank account details for ABP income payments) and the possibility that Age Pension entitlements could be impacted. While such a compulsory default mechanism runs counter to the pro-choice sentiment outlined by the Government, it could be justified on consumer protection considerations.

Closing comments

[24] Trustees currently have no obligation or incentive to do anything when members meet the age-related condition of release.

[25] This default could be designed to allow full flexibility under a scenario where the member subsequently engages.

Marrying up retiring fund members with a retirement solution that accords with both their desires and their needs is arguably *the* major challenge facing the superannuation industry in catering for retirees. We argue that solely relying on retiring members to choose for themselves – be it either self-directed or advised – might not suffice to deliver reasonable outcomes for all types of retirees. We suggest that some retirees might welcome *another kind of choice*: the option to ask their super fund to select a solution on their behalf, either as a recommendation or an assignment. An effective method for achieving this would be to place an obligation on super fund trustees to engage with their members at retirement to establish their preferred mode for identifying a suitable retirement solution, which funds would then be required to deliver.

Consideration should also be given to how the retirement system will address the heavily disengaged who do not choose at all. While a default mechanism or the development of automatic transfer policy (potentially with the ability to opt-out) would provide a solid safety net, a second-best alternative might be to place onus on the trustee to continue seeking engagement with such members to confirm their wishes.

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