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Retirement explainer series

Pathways to retirement solutions

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Brief synopsis: This explainer describes the potential pathways through which superannuation (super) fund members could find their way to a suitable retirement solution. Five distinct pathways are identified and discussed, including *self-direction*, *adviser direction*, and three forms of *trustee direction* – recommendation, assignment and default. Differing pathways can cater for the differing ways that members engage with financial decisions for retirement. 'Nudges' by super fund trustees might be viewed as sitting in a grey area between self-direction and trustee direction.

Questions addressed:

1. What are the various pathways for identifying a suitable retirement solution for retired members?
2. What issues are presented by each pathway?
3. How might 'nudges' be viewed within the pathways framework?

Key terms: Choice architecture; self-direction; adviser direction; trustee direction; member engagement; guidance; financial advice; nudges; defaults

Who should be interested? Retirement specialists, retirement leads, member experience personnel, financial advisers, policy makers, regulators, people wanting a career in the retirement income space

Introduction

This explainer addresses the general topic area of the 'choice architecture' for retirement solutions. Potential 'pathways' are discussed through which super fund members could find their way to a retirement solution that is suitable for their needs. Here we mainly provide a high-level summary of a Conexus Institute paper[1] that details the pathways that readers might access to further explore the topic. We also consider 'nudges' as proposed under the Delivering Better Financial Outcomes (DBFO) reforms[2] in the context of the pathways framework.

The underlying theme is that members differ in how they engage with financial decisions for retirement, which creates a need for differing 'decision' pathways. We scope out five potential pathways: *self-direction*, *adviser direction*, and three forms of *trustee direction* including recommendation, assignment and default. Our organising structure is based around which of three parties plays the primary role in identifying a retirement solution – a fund trustee, a financial adviser, or the member themselves. The table over summarises the main features and key issues for each pathway. Nudges by trustees are discussed later as sitting in a grey area between self-direction and trustee direction, noting that providing a nudge still requires members to exercise choice on some level.

[1] *"Pathways for directing members into retirement solutions"*, November 2023

[2] https://treasury.gov.au/sites/default/files/2023-12/p2023-471470.pdf.

Overview of pathways to a suitable retirement solution

Pathway	Self-direction	Adviser direction	Trustee direction		
	Member choice	Personal financial advice	Trustee recommendation	Trustee assignment	Default
Main features	Member chooses solution, drawing on decision support services	Member is directed to a solution by a financial planner through: (a) limited advice, or (b) comprehensive advice	Trustee recommends a solution to member, who then opts-in or opts-out	Member requests trustee to assign them to a solution	Trustee defaults member into a (probably basic) retirement solution
Member type most suited for	Members who want to choose for themselves	Members who desire a personalised recommendation and are willing to pay	Members looking for direction, but: • Do not want to seek a financial adviser • Not well-prepared to choose for themselves		Highly disengaged members who take no action
Key issues	• Complexity of decisions and products • Literacy, behavioural and cognitive limits • Decision support needs development	• Trade-off between complexity and cost • Capacity of financial advisers is constrained	• Reliance on funds to offer range of solutions suitable for all members • Trustees need to be able to readily access and use personal information for pathway to operate effectively • Members may place reliance on trustees, limiting access to independent perspectives and competitive tension		• Satisfying the conditions for default to occur • Risk of assigning members to unsuitable solutions in absence of any engagement

Self-direction

The self-direction pathway involves the member identifying a retirement solution for themselves. This would likely occur with assistance, including: sourcing information on available products, solutions and strategies; decision support tools such as retirement calculators; using general advice and possibly low-cost limited advice supplied by their super fund; accessing online resources; and possibly seeking input from family and friends. Nudges might be used to influence member choice, noting that the member is required to engage with the nudge and exercise an element of choice even if just whether to accept what is being presented.

A member choosing from a list of options offered by their superannuation fund would fall under self-direction, as the member is required to understand the options and choose for themselves. This could be implemented by presenting 'personas' with which the member self-identifies possibly denoting one solution as the 'default' for that member type.

The self-direction pathway caters for those members who want to choose for themselves, and ideally are capable of doing so effectively. Self-choice is a necessary component of any choice architecture. However, it faces various limitations as outlined below that create a strong need for other pathways.

The survey evidence we have seen suggests that around 20% of members might prefer self-direction.

The key limitation of the self-direction pathway relates to the difficulty in many members making informed financial decisions due to a combination of high complexity and limited cognitive ability. Retirement decisions are complex because they entail investing assets to generate income over a long period of time under uncertainty over both investment returns and how long the member might live. Available financial products can be difficult to understand, in particular lifetime income streams (annuities) where a wide range of design features are emerging. Deciding how much can be safely drawn is also a very challenging, dynamic problem.

Decision-making capability can be limited for various reasons. Many members lack financial literacy and may be subject to cognitive limitations. They can be subject to behavioural effects such as narrow framing, inertia, availability biases, myopia, and so on. Cognitive decline, propensity to take advice from poorly-informed players (e.g. friends, online sources) and vulnerability to scammers could be at play. Many members simply do not have the capability to make a well-informed decision on what type of retirement solution suits their needs.

The current state of decision support services is another issue faced by the self-direction pathway.

Information on products and solutions is often provided in a form that is hard for members to understand. Self-directed members do not currently have access to any services that compare products and solutions across providers. Many of the available decision support tools are limited in scope. For instance, they may consider only the allocation between growth and defensive assets while ignoring lifetime income streams, apply basic drawdown rules, and fail to effectively take risk into account. Decision support services need considerable further development if the self-direction pathway is to operate effectively.

Adviser direction

We define adviser direction as the member paying for personal financial advice entailing either recommending a retirement solution or constructing one from available products. Personal financial advice may be limited or comprehensive in scope. Here, limited advice could pertain only to the retirement solution. Comprehensive advice can provide a broad set of recommendations beyond the retirement financial plan, potentially including areas such as wealth management, estate planning, tax and so on. Limited advice can be offered at lower cost than comprehensive advice. Some estimates put the average cost at around $2,000 for limited and $3,500-$4,000 for comprehensive advice.

Personal financial advice offers the potential for 'gold standard' guidance, if done well. However, two substantial hurdles limit the potential footprint of the adviser direction pathway.

First is supply constraints. The number of financial advisers has fallen below 16,000, and there are limits to how many clients an adviser can effectively handle. Further, advisers tend to favour richer clients. The second hurdle is cost. The constraints around cost relate to both the aversion of many members to pay (much, if anything) for advice, and cost effectiveness of advice for low wealth members.

Advice capacity might be expanded and costs reduced through simplifying the advice process, which is one focus the Government is considering under the DBFO reforms. Wider incorporation of digital tools could also help.

While hard estimates are difficult to come by, indications are that around 10% and at most 20% of members are currently seeking or using financial advisers – many of whom would be categorised as high wealth. While the percentage of members using advice might be increased, it seems unlikely that the advice pathway will get anywhere near being able to cater for the majority of retirees.

Trustee recommendation and assignment

This leads us to the trustee direction pathways. We deal with trustee recommendation and assignment together as they entail similar delivery mechanisms. However, they would necessitate different legal frameworks due to the distinction between a recommendation that is more like a type of advice, and an assignment that is more in accord with a form of defaulting process under request. 'Hard' defaults where the member has little or no involvement are addressed further below.

Trustee recommendation entails the trustee identifying a suitable retirement solution *for* the member and recommending that solution to them. The member could then decide whether to accept the recommendation, or either choose an alternative solution or possibly enter another pathway. Trustee assignment would involve the member requesting that the trustee chooses a solution on behalf of the member and assigning them to that solution. We envisage an opportunity to opt-out before final assignment as a last check.

The trustee would need to source and use personal information to identify a suitable retirement solution under these pathways. Consider a cohorting approach where member cohorts are formed and retirement solutions built for each cohort. Under this approach, the trustee would need to use personal information to identify the cohort to which the member belongs to recommend or assign them to a suitable solution. Personalised tailoring could require more detailed member information to inform the design of a tailored solution.

The trustee recommendation and assignment pathways can play three roles:

(a) *Assisting members* who are looking for guidance but do not want to seek a financial adviser and are not well-prepared to choose for themselves. This group could be 60%-70% of retirees.

(b) Matching members with suitable retirement solutions in a *scalable and efficient* (i.e. low cost) way. For instance, the cohort-based process described above could be scaled by constructing solutions by combining basic investment building blocks[3] and drawdown rules.

[3] Solutions might be formed from growth and defensive portfolios and a small number of lifetime income streams.

(c) A *mechanism to encourage better choice* through embedding appropriate elements within retirement solutions, such as take-up of lifetime income streams or drawing down income at higher rates where appropriate to do so. While comparable nudges might be built into the self-direction pathway through how solutions are offered, nothing beats a clear recommendation.

Three key issues arise with the trustee recommendation and assignment pathways. First is the reliance on super funds to be able to offer a suite of retirement solutions that are suitable for all members. The main hurdle here is catering for the wide range of member differences as discussed in Explainer #4. Trustees also need to solve for personal needs that span multiple dimensions while only being responsible for the member's assets managed by the super fund.

Second is the need to use personal information for these pathways to operate effectively. Currently it is not possible for a trustee to collect and use personal information to recommend (let alone assign) a member to a retirement solution without becoming subject to the high cost requirements accompanying the provision of personal financial advice. Adjustments to the advice rules are required to allow these pathways to operate in a scalable and efficient manner, while still ensuring that members are protected from poor outcomes.

The third is the 'vertical integration' issue. Placing members in a position where they may be relying on trustees will limit access to independent perspectives and competitive tension. There is no clear path to redress if a trustee offers substandard or poorly matched retirement solutions that the member accepts out of trust.

Trustee default

This pathway involves the trustee defaulting a member into a retirement solution without prior assent. 'Hard' default without engagement seems problematic, but is highlighted for two reasons. First is for completeness, i.e. to span the entire spectrum of possibilities. Second is that a default mechanism may be the only way of catering for, and protecting, members who are highly disengaged and may not otherwise shift their balance into the tax-free environment of retirement.

One hurdle in defaulting members into a retirement solution is ascertaining if default is appropriate. There could be good reasons for a member remaining in accumulation such as personal preference, not having retired, or being over the $1.9 million transfer balance cap possibly due to having multiple accounts. Operational aspects need to be sorted, such as bank account details so that income can be paid. Either some engagement with the member or another avenue for sourcing this information is required.

Another issue is the risk of assigning members to unsuitable solutions in absence of any engagement. This risk might be minimised by defaulting members into basic retirement solutions such as an account-based pension that applies the minimum drawdown rules, thus limiting potential for harm and maximising flexibility to readjust later.

Nudges

We discuss nudges in light of the Government contemplating facilitating trustees to 'nudge' members through the DBFO reforms. While the scope of such nudges is yet to be decided[4], the Treasury *Retirement phase of superannuation* consultation paper[5] of December 2023 refers to 'default settings' and 'default solutions'. (*Comment*: Treasury seems to be alluding to various forms of limited recommendation, rather than true defaults.)

The table over aims to make some sense of these possibilities by portraying a 'choice spectrum' spanning various roles that might be played by members and trustees in identifying a suitable retirement solutions. The spectrum ranges from self-direction on the left where the member is responsible for selecting a solution, to assignment and defaults on the right which are treated in this table as two forms of default. The trustee provides an increasing level of direction to the member in moving from left to right.

[4] The DBFO nudges could involve prompts to take action (e.g. consider Age Pension application or the retirement needs for member who appear to be retired), rather than suggestions related to the retirement solutions or their components.

[5] https://treasury.gov.au/sites/default/files/2023-12/c2023-441613-dp.pdf

Choice spectrum for retirement solutions: Roles of members and trustees

Self-direction *(member choice)*	Recommended settings *(limited nudges)*	Recommended solutions for member types *(firm nudges)*	Trustee recommendation of a comprehensive solution *(very strong nudge)*	Trustee assignment and trustee default *(forms of default)*
Member initiates action and makes decisions	*Trustee directs member in some way*			*Trustee assigns member*
• Trustee provides solutions, products and services, e.g. decision tools, information • Member engages with fund offerings and makes choices • Accommodated by current financial advice rules; amounts to the *status quo*	• Trustee provides solutions, products and services that include recommended default settings • Member engages with fund offerings and makes choices cognisant of default settings • Examples of default settings: - recommended drawdowns - lifetime income streams for certain balances - asset mix within account-based pension	• Trustee offers set of recommended default solutions designed for member types (sub-classes) as defined by cohorts or personas • Member engages with options offered; may adopt solution based on self-identified member type, or choose from other solutions and products on the menu	• Trustee collects personal information and uses it to recommend a retirement solution to the member • Could be based around either member cohorts or personal tailoring • Member only required to request recommendation, which they may then accept or reject	• Trustee directly assigns member to a solution, either on request or upon no action • Trustee attempts to collect personal information to effect assignment • Legislation required to enable trustees to assign members

Sitting between self-direction and default are three forms of recommendation that are characterised as nudges of varying strength. Recommended settings (e.g. suggested drawdown strategies) are considered limited nudges. Recommended solutions for member types – where the member needs to engage and understand the process of self-identifying with a member type – are denoted firm nudges. Trustee recommendation as discussed further above is considered a very strong nudge, with the member being presented with a definitive recommendation.

The distinguishing feature between trustee recommendation and the weaker forms of nudge is that the trustee is choosing a retirement solution *for* the member. This has the effect of allowing the member to make no financial decisions if they do not wish. The difference is subtle, but important as it caters for members who do want to – or cannot – engage with financial decisions on any level.

Our take: Trustee direction should be facilitated

The main message is that members differ significantly in how they engage with retirement decisions, and thus a range of pathways is required. rom this perspective, currently the major missing component of the choice architecture is the trustee direction pathway. We strongly believe that policy makers should be aiming to facilitate at least one – if not all – of the three variations of the trustee direction pathway. In the absence of doing so, many retirees could be left receiving either no guidance, or being prompted to choose for themselves although lacking capacity to do so effectively. Many members may welcome clear direction from their super fund on what retirement solution seems most suitable for their needs.

The trustee recommendation pathway might be easiest to facilitate as it requires least adjustment to the system architecture, apart from accommodating the collection and use of personal information by trustees in an efficient manner. Trustee assignment or default would need a change in policy to enable funds to assign members to a solution. Retirement defaults would be more challenging to implement as they also require changes to industry architecture to support checks that default without engagement is appropriate and to support making payments.