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## Default Pension Mechanism

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# Default Pension Mechanism

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## **Abstract**

This paper discusses the benefits and impact of a new default mechanism within the Australian superannuation system which automatically transfers retired members' retirement savings from accumulation phase to pension phase.

The proposed mechanism would allow members to benefit from tax-free investment earnings, and ensure they fully benefit from their accumulated retirement bonuses.

This paper further covers practical considerations of how the mechanism can be embedded into product design, details of how the mechanism would operate in practice, administrative nuances, legal considerations, and mitigation strategies against potential unintended consequences.

## **Key words:**

Superannuation; disengaged members; retirement; pension product; default

## Introduction

The Retirement Income Covenant, which took effect from 1 July 2022, requires RSE licensees to formulate a retirement income strategy setting out how they will support their members approaching retirement and in retirement, supported by the monitoring of success metrics.

One of the success metrics adopted by funds is the number and proportion of members that are likely to have retired<sup>1</sup> remaining in accumulation phase accounts<sup>2</sup>. These members who remain accumulation phase miss out on:

- Tax-free investment returns, and
- Cashing in on their accumulation retirement bonus, and
- An additional source of retirement income.

This paper explores the benefits of a default mechanism that automatically transfers retired members from an accumulation phase product to an account-based pension product.

## Sizing the opportunity

Challenger estimates that there are 1.3 million superannuation accounts for members aged 65 years or more have not been moved to pension phase<sup>3</sup>.

We estimate that our proposed mechanism would affect 1 million members with total account balances of \$398 billion<sup>4</sup>. This is a conservative estimate, which only includes members at APRA-regulated funds<sup>5</sup>. The figure would be higher if we had included non-APRA-regulated funds as well. Full explanation of our proposed mechanism is explained later in this paper.

By moving members to pension phase, we estimate that our proposal would lead to:

- \$1.99 billion in additional investment earnings in a single year, and
- \$1.99 billion in accumulation retirement bonuses distributed to members, and
- \$20.7 billion in retirement income paid to members to spend in the wider economy and improve their standard of living.

Full details of how these figures are estimated are explained later in this paper.

## Learning from past successes

This situation is comparable to the issue of account balance erosion by insurance premiums on inactive accounts prior to the Protecting Your Super (PYS) legislation coming into effect on 1 July 2019. In both cases, the core underlying issue was member disengagement. For a vast majority of these disengaged members, it would have been in their interest to cancel their insurance, but the onus was on the member to make such a choice - a choice that many do not make - even when nudged to do so.

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<sup>1</sup> Reached preservation age and are not making contributions

<sup>2</sup> APRA industry update – Pulse check on retirement income covenant implementation

<sup>3</sup> <https://www.afr.com/companies/financial-services/1-3m-australians-may-be-paying-tax-they-don-t-have-to-20230825-p5dzco>

<sup>4</sup> Laneway Analytics' analysis of APRA fund level statistics and proprietary data

<sup>5</sup> Estimate limited to APRA-regulated funds due to dependency on APRA data to complete analysis

The government addressed this issue by introducing the PYS legislation that soft defaults members into cancelling their insurance coverage if they had been inactive for 16 months. The legislation requires superannuation funds to notify affected members with 9, 12, and 15-month notices in the lead-up to cancellation. During this time, they could opt in to keep their insurance if it better suited their circumstances.

We borrow from this successful experience and propose a similar default mechanism for retired members.

### **Why default?**

While member guidance and member education serve a role in nudging these members to make a choice, it would serve little help for the most disengaged members.

This is not to say that member guidance and member education are not effective, but given the sheer volume of members missing out and the amount of affected FUM, even an assumed high call-to-action success rate of 10% would still see too many members continue to miss out.

Furthermore, we can demonstrate that the default option proposed in this paper is in the members' best interest, for the vast majority of members. We estimate that less than 0.1% of members would experience a worse financial outcome. These members are described in more detail later in this paper.

### **The proposed mechanism**

This proposes a similar default mechanism as in the PYS legislation to transfer retired members meeting certain criteria into their superannuation fund's account-based pension product.

These criteria are:

- The account meets the minimum balance requirement for opening an account-based pension<sup>6</sup>, and
- The member does not already have a Transition to Retirement (TTR) or pension account with the fund, and
- The member is 60 or older and the member's account has not received an employer super guarantee contribution for 16 continuous months<sup>7</sup>, or the member is 65 or older<sup>8</sup>.

Additional features of this proposal are:

- Existing investment options and insurance coverage would be maintained.
- Members would be sent 9, 12, and 15-month notices in the lead-up to the soft default mechanism being triggered, where they could opt out of the transfer.
- Drawdown amount would be set to the legislated Minimum Drawdown Rate (MDR).

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<sup>6</sup> Different funds have different minimum balance requirements. In our modelling, we have taken the conservative approach of assuming a minimum balance requirement of \$50,000, which is highest amount currently quoted in the market. The minimum balance requirement can be as low as \$10,000.

<sup>7</sup> To meet the condition of release "ceasing an employment arrangement on or after 60"

<sup>8</sup> To meet the condition of release "is 65 years old or older (even if they haven't retired)"

- Drawdown amounts would be automatically recontributed to the member if a bank account is not nominated.

### The retribution mechanism

The 9-month, 12-month, and 15-month notices in the lead-up to the soft default mechanism being triggered will ask members to provide their bank details to allow for the minimum drawdown amount to be paid to them.

If the member does not provide their bank details, the fund would by default make the payment as a non-concessional contribution into a new accumulation account in the member's name on the last day of the financial year, and then reboot the pension account with the total combined amounts on the first day of the following financial year.

This information would be included in the 9-month, 12-month, and 15-month notices.

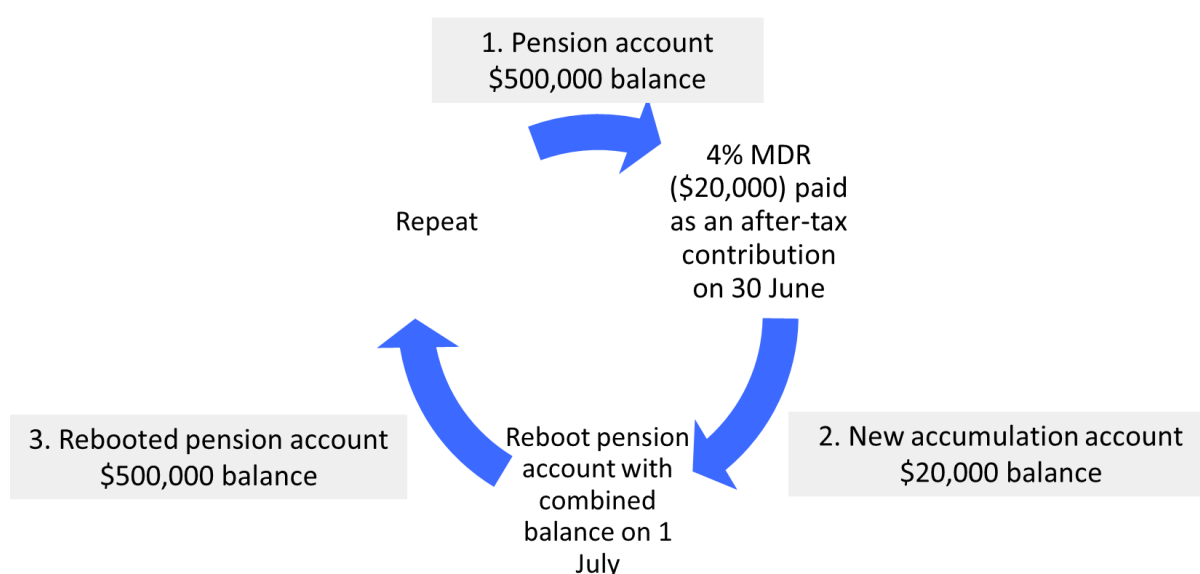


Figure 1 The retribution mechanism

This is effectively a re-contribution strategy.

The common steps members currently undertake to manually retribute money into super are:

1. Regular pension payments are paid to the listed bank account of the member's pension account
2. An amount equal to the regular pension payments are paid to the member's (new or existing) accumulation account as a non-concessional after-tax contribution
3. Reboot the pension account with the combined balance of the accumulation account and the existing pension account

Our proposal combines steps 1 and 2, which removes the requirement for the member to act from the process.

We acknowledge that there will be additional burden placed on the administrator to process the notices and the retribution strategy, but the same can be said of almost all regulatory changes.

**Impact on contributions caps and transfer balance cap**

The re-contribution strategy described above will use some of the member's non-concessional contribution cap and transfer balance cap without their explicit permission.

It will lead to a marginally worse financial outcome in circumstances where members had otherwise intended to use the full non-concessional contribution cap (currently \$120,000pa) and transfer balance cap (currently \$1.9 million).

This is the only group of members who would suffer a worse consequence under the proposed mechanism. It is estimated that there are less than 0.1% of members in this group<sup>9</sup>.

Members who intend to maximise on their caps are likely be more engaged – they are unlikely to meet the proposed criteria for the mechanism in the first place, or they could simply opt out.

**How do we justify this approach?**

Recontribution only applies when a bank account is not nominated by the member.

Under such conditions, the recontribution strategy maximises the members' financial interest while keeping the same functional outcome. Let's compare the three scenarios below.

1. Under the current system, the member does nothing and their superannuation remains in accumulation phase.

They cannot access their money until they take action by requesting a benefit payment from their super fund or by moving their money to pension phase.

They derive no utility from their superannuation.

2. If we do not take the approach of recontribution, we would have to pay out the minimum drawdown amount to a bank account, either by:

- a) Opening a new bank account in their name on their behalf, or
- b) By identifying their current bank account details via some other means such as open banking.

In option a, the member will not be able to access their money until they take control of the bank account by completing proof of identity checks. This means the member will derive no utility from their superannuation until they take action, just like under the current system. Additionally, part of their superannuation would now be banked as cash instead of being invested. This is objectively a worse financial outcome for members and therefore should not be considered.

In option b, the member will need to consent to data sharing. This still requires action from the member. Additionally, adoption of open banking remains low. There are reported data quality issues which means that secondary verification and proof of identity checks should still be completed. Furthermore, even if members do begin the consent process, the current industry average consent attempt completion rate is

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<sup>9</sup> Laneway Analytics' analysis of APRA fund level statistics and proprietary data

27%<sup>10</sup>. We can expect it to be even lower for the less tech-savvy older demographic. We can therefore conclude that option b is not a viable option at this stage.

3. With the proposed retribution mechanism, members similarly cannot access their money until they take action by providing their bank details, and as such derive no utility from their superannuation.

This is the same functional outcome as under the current system, but now the member gets to benefit from:

- Tax-free investment returns
- Retirement bonus
- Reduce tax obligation on superannuation death benefit

This is objectively the best option to maximise members' financial interests.

### Reduced tax obligation on superannuation death benefit

A benefit of the retribution strategy is the reduced tax obligation on any superannuation death benefits paid to the members' estate or beneficiaries when the member eventually dies. The tax is only applicable to the taxable component of super, and only when the benefit is paid to non-dependants of the deceased.

Non-concessional contributions count towards the tax-free component of super. This means that every retribution made through retribution mechanism increases the proportion of the tax-free component of the member's superannuation balance, and therefore lowers the tax obligation on the final superannuation death benefit when it is paid out to their non-dependants.

For a 60-year-old member who has never made a voluntary contribution and initially begins with 100% of their superannuation balance being taxable, 10 years of recontributions would reduce their taxable component to 66%. Over 25 years this would reduce further down to 25% (Figure 2).

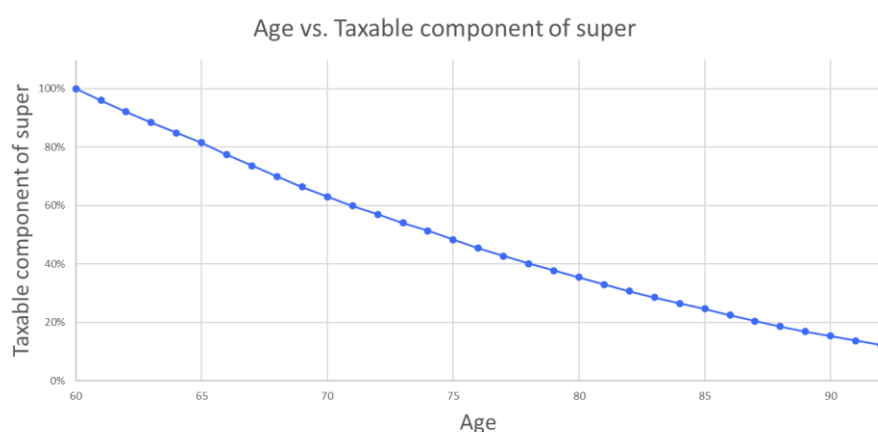


Figure 2 Effect of retribution strategy on taxable component of super

<sup>10</sup> <https://blog.frollo.com.au/open-banking/>

## Considerations of unintended consequences

In designing any default system, it is crucial to anticipate and address potential unintended consequences. This proposal may have several unforeseen effects. Below, we outline some of these possible outcomes and propose corresponding mitigation strategies.

We also examine how our choice of selecting an account-based pension allows this proposed default mechanism to adhere to the principle of do no harm.

### **What if the member later realises that an account-based pension is not suitable for them?**

The design of an account-based pension product allows members to commute part or all of their pension, including but not limited to:

- Commute to an accumulation phase product
- Purchase a lifetime pension product
- Lump sum withdrawal as cash
- Complete rollback: Commute back into the accumulation phase and re-contribute any pension payments<sup>11</sup>

If the member later decides that they want to take some of their retirement savings out of super as a lump sum or to purchase a retirement product at a different service provider, it is generally always in their best interest to first transfer to a pension product within their fund, receive their retirement bonus, wait out any claw back period where necessary, then make a redemption.

Members who directly make a redemption from their accumulation account miss out on this bonus, which can be very significant especially if they are very long-tenured members.

### **What if the member continues / later resumes work?**

If the member receives an employer contribution, existing account stapling provisions would mean that they would automatically have a new accumulation account set up for them within the same fund.

The combined balance would be used to reboot the pension account via the retribution mechanism once a year to maximise their investment potential.

### **What if the member does not want the additional income from their pension account?**

This question would only be applicable if the member has provided their bank details and received the pension payments in their listed bank account.

The member has the choice to re-contribute the money back into their super fund at any point, provided they do not breach their contribution caps. This is default set by our retribution mechanism.

Alternatively, if they can also leave it in their bank account to collect interest or invest it outside of superannuation.

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<sup>11</sup> Provided they do not breach their contribution caps



## Impact

We estimate that there are 1 million members with \$398 billion that meet the listed criteria for the proposed mechanism. This is a conservative estimate that only includes members at APRA-regulated funds. The figure would be higher if we had included non-APRA-regulated funds as well.

Furthermore, we have based this estimate on a minimum account balance requirement of \$50,000. This is the highest minimum account balance requirement currently on the market – some funds require as little as \$10,000 for an account-based pension account to be opened.

*Table 1: Impact of mechanism from FY2021 to FY2024*

	Number of members	FUM	Lost earnings	Retirement bonus
FY2024	1,064,000	\$398 billion	\$1.99 billion	\$1.99 billion
FY2023	977,000	\$343 billion	\$1.715 billion	\$1.715 billion
FY2022	844,000	\$286 billion	\$1.43 billion	\$1.43 billion
FY2021	742,000	\$256 billion	\$1.28 billion	\$1.28 billion
<b>Total</b>			<b>\$6.415 billion</b>	

*Source: Laneway Analytics' analysis of APRA fund level statistics and proprietary data*

Over the last four years, the number of qualifying members had increased 43%, whereas the total amount of affected FUM increased by 55% (Table 1).

We expect the figures to continue to increase as the baby boomer generation reaches retirement age.

In our analysis, we found that more than 90% of members who appeared on the list in one year appeared again in the following year, highlighting the prevalence of extended inaction and the need for such a default mechanism.

### Tax-free investment return

Investment earnings in accumulation phase are taxed at 15%<sup>12</sup>, whereas earnings in pension phase are tax free.

Assuming that members could achieve a 6.5% rate of return (net of tax and fees) in pension phase instead of 6% in accumulation phase<sup>13,14</sup>, it would represent \$1.99 billion in additional investment return to members in FY2024 and is expected to continue to grow in future years as disengagement continues.

Over the last 4 years, the total potential lost investment earnings was \$6.415 billion.

<sup>12</sup> The effective tax rate may be lower after considering franking credits and capital gains tax discount

<sup>13</sup> Typically quoted expected long-term rates of return for the Balanced investment option

<sup>14</sup> Effective tax rate of 7.7% in accumulation phase and 0% in pension phase

## Retirement bonus

The retirement bonus is money set aside to pay for expected capital gains tax that is released to the member when they move their money from accumulation phase to the tax-free retirement phase via the transfer balance cap.

Assuming an average retirement bonus rate of 0.5%, it would represent \$1.99 billion in tax savings waiting to be passed onto members. This is a conservative figure, as some funds offer a retirement bonus rate of up to 1.25%.

Similarly, we expect the figure to continue to grow in future years as disengagement continues.

## Retirement income stream

Members derive utility from income.

Assuming an average minimum drawdown rate of 5.2%<sup>15</sup>, it would represent up to \$20.7 billion in value released to members, which they could then use to either pay down debt or spend in the wider economy.

This is increasingly important to Australia as we become increasingly dependent on consumption to drive economic growth.

## Impact on an “average” individual

We consider John Smith, a 65-year-old retired worker with \$374,000<sup>16</sup> in superannuation.

If he stayed in accumulation at an average fund, he could expect to have \$425,000 by the time he reaches age 75.

If John Smith’s fund had implemented a default mechanism as we propose, his fund would commence an account-based pension immediately, and John would receive \$1,870 in retirement bonus. He will then benefit from tax-free investment earnings, with his superannuation balance reaching \$448,000 by the time he is 75. That’s a difference of \$23,000 or 5.4%.

Table 2 below shows the impact on John over different time periods.

*Table 2: Impact on John’s superannuation balance*

	0 year	1 year	5 years	10 years
Account balance (Stay in accumulation)	\$374,000	\$380,000	\$399,000	\$425,000
Account balance (Soft defaulted to pension)	\$375,870	\$384,000	\$412,000	\$448,000
<b>Difference</b>	<b>\$1,870</b>	<b>\$4,000</b>	<b>\$13,000</b>	<b>\$23,000</b>
<b>% Difference</b>	<b>0.5%</b>	<b>1.1%</b>	<b>3.3%</b>	<b>5.4%</b>

*Source: MoneySmart superannuation calculator*

<sup>15</sup> Weighted average rate of minimum drawdown based on the age distribution of members meeting the listed criteria

<sup>16</sup> Average balance of a member who meets the criteria of the proposed mechanism

## What's stopping us from doing this?

### Disclaimer

The following section highlights some of the legal issues that require attention.

We have not consulted with legal professionals to create an exhaustive list of all potential risk and compliance issues that may arise from our proposed mechanism.

We welcome input from the profession to create a more complete list and subsequent action plan.

### Design and Distribution Obligations (DDO)

There are currently TTR products that automatically become pension products on the member reaching age 65 as defined in the PDS. Can the same mechanism be embedded in the PDS's of accumulation products?

Unfortunately, no. MySuper products are DDO exempt. There are no pension products which are DDO-exempt. We are currently unable to default members from a DDO-exempt product into a product that requires DDO checks.

We would require the account-based pension product to receive an exemption for the DDO regime similarly to how MySuper currently receives it.

This could be called MyPension – the other half of the default super system intended by Jeremy Cooper in the Super System Review of 2010.

### The retribution mechanism

It is unclear if it is legally possible to open an account-based pension without a listed bank account for processing payments. We have observed pension accounts with no listed bank accounts within administration systems<sup>17</sup>, but they may represent administrative errors rather than an intended feature.

It is also unclear if it is legally possible to make payments in the form of non-concessional contributions into an accumulation account. The common steps members currently undertake to manually retribute money into super are:

1. Regular pension payments are paid to the listed bank account of the member's pension account
2. An amount equal to the regular pension payments are paid to the member's accumulation account as a non-concessional after-tax contribution
3. Reboot the pension account with the combined balance of the accumulation account and the existing pension account

Our proposal combines steps 1 and 2, which removes the requirement for the member to act from the process. Funds, with their risk-averse nature, are likely to require explicit guidance from the regulator to invest in the administrative upgrades needed to support this new retribution process.

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<sup>17</sup> Not uncommon observation – up to a third of all current pension account at some funds

## Conclusion

There are over 1 million Australians missing out on \$2 billion every year in tax benefits that they are entitled to under the superannuation system. Both figures are expected to grow in the future as the baby boomer generation progressively reaches retirement age. The sheer size of the numbers and the core underlying issue of member disengagement, supports the rationale for regulatory intervention via the implementation a default pension system to ensure that members do not continue to miss out on these benefits.

We have proposed a default pension mechanism that we have demonstrably shown to be in members' best financial interest, limits lesser outcomes to a very small cohort of members, while preserving members' choice to do with their retirement savings as they wish.

We seek further support from the broader Actuarial profession to provide feedback and advocate for this change.