SUPERANNUATION: CHOICE, COMPETITION AND ADMINISTRATION COST

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Australian superannuation is a funded pension system in which workers accumulate assets in personal accounts held at one of over 2000[1] superannuation funds. A recognised problem of such systems is administrative expense. However, policy makers rejected the option of a more centralised structure when implementing Award and compulsory super in the 1980s and early-1990s, due to it being inconsistent with the approach of extending the coverage of existing employer superannuation arrangements for public sector workers and private sector executives, and because of claimed risk diversification benefits from a plural system (Robinson, 1992: 8).

Annual fees in Australia are estimated to average 1.27 per cent of assets (Rice, 2003: 1). Using the rule of thumb that asset based fees cause a 20 fold reduction in accumulation at retirement (Diamond, 2000: 15), this level of fees reduces lifetime super accumulation by around 25 per cent. Almost no direct action has been taken by government since introduction of compulsory super in 1992 to reduce the impact of fees on superannuation accumulation.[2]

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1 This count excludes over 14,000 'small funds', which have less than 5 members and are tax-effective saving vehicles for relatively wealthy families.

2 The Keating government prohibited fees on accounts with balances below $1,000 but at the cost of all earnings. The current government is working with the industry to improve disclosure, and supports greater competition between super funds. The limited potential benefit of these initiatives is discussed below.

Australian superannuation operates in a unique regulatory setting reflecting its phased evolution. In general, workers and retirees can choose the fund (from over 300 'public offer' funds) which houses assets accumulated in *previous* employment. However, contributions related to *current* employment are directed to a fund which is either chosen by the employer or determined by industrial conditions.

Some leading superannuation researchers attribute high administration costs (and low investment performance) to agency issues resulting from this constraint on competition (Drew and Stanford, 2003: 103). Accordingly, they support the current Federal government's plan to allow member 'choice of fund' for all superannuation assets. The claim of such economists is that market competition disciplines funds; offering incentives for efficient operation (Drew and Stanford, 2003: 105).

This article argues that such an approach ignores cost issues inherent in personal account based pension systems, especially with non-centralised account administration. It also ignores the *added costs* associated with competition observed both here and overseas.

The article also explores the question of whether or not free choice will result in price and performance competition among super funds. Perceived obstacles to price competition include inadequate disclosure, complexities in superannuation products and pricing, limited consumer interest and financial skills, and commission-based selling by financial planners.

The analysis suggests that free choice would compound rather than alleviate current problems related to fees. Reform is needed to achieve a reasonable level of fees within this structure. The analysis supports movement away from a model of direct consumer choice, towards an 'institutional market' such as that already implemented in the private funded component of the Swedish pension system. Account administration in that market is public and centralised, preventing account proliferation and maximising administrative economies of scale. Consumers choose from a relatively limited range of funds and investment options. Fund management is conducted by private firms which periodically bid for licenses at auctions run by government. This

competition 'for the market' rather than 'within the market' provides more effective discipline on providers.

The Cost of Administration in Superannuation Funds

That administration cost has a significant negative impact on retirement savings in superannuation schemes is in little doubt. Surveys on superannuation administrative cost are commissioned periodically by two industry bodies, IFSA (Investment and Financial Services Association) and ASFA (Association of Superannuation Funds of Australia). The Australia Prudential Regulatory Authority (APRA) publishes the results of a quarterly survey on funds including operating cost, and, in 2003, published a detailed analysis of fund performance and administration by Coleman, Esho and Wong (2003).

A recent ISFA survey (Rice, 2003) found that annual fees average 1.27 per cent of assets. Seemingly small asset based fees such as these have a dramatic effect on accumulation over the long term. Peter Diamond (2000: 15) uses the rule of thumb that annual asset based fees are roughly proportional to reduction in accumulation with a factor of 20. This is consistent with recent modelling by Hazel Bateman (2001 in Coleman et al, 2003) which suggests that one per cent annual asset based fees reduce accumulation at retirement by 22 per cent. These approaches suggest that the average annual asset based fee of 1.27 per cent results in an average reduction in retirement accumulation of between 25 and 28 per cent.

Fees on any one account can vary greatly around this average. An important source of variation is fund type. Superannuation contributions are made to one of over 2000 approved 'non-small' funds, of which there are several distinct types. Public sector funds offer services exclusively to public sector employees. Corporate funds are run by large private sector employers for their own employees. Retail funds are private financial institutions offering services to employers, the self-employed and other individuals. Industry (or 'multi-employer') funds were created in the 1980s to receive Award contributions in specific industries. Since 1997, industry funds have been able to apply to APRA for 'public offer'

status, which allows them to take contributions from employers and individuals outside their original industry.

Table 1 summarises recent surveys of superannuation administration cost by fund type. Public sector and corporate funds have the lowest average annual administration cost at around 0.5 per cent and 0.8 per cent of assets respectively. Industry funds are close to the industry average at around 1.2 – 1.3 per cent. Retail funds for employers (master trusts) are closer to 1.5 per cent. Retail funds for individuals are the most expensive at around 2.25 per cent excluding upfront fees and 3.25 per cent if upfront fees (typically 5 per cent of contributions) are included and averaged over 5 years.

Table 1: Estimates of Average Annual Administration Fees (as a percentage of assets) by Fund Type

Type of Fund		ASFA Estimate (June 2003)	ASFA Estimate (June 2000)	IFSA Estimate (June 2002)
Industry	Large (>$1 bn assets)	0.5 - 1.0		
	Small (<$1 bn assets)	1.0 – 1.5		
	Combined		1.35	1.23
Corporate			0.78	0.86
Public sector		0.4 – 0.5	0.49	0.59
Retail	Personal (excl upfront fees)	2.0 – 2.5		2.23
	Personal (incl upfront fees*)	3.1 - 3.5		
	Master trust	0.8 – 1.9		1.45
	Combined		2.40	2.00

* Upfront fees averaged over 5 years.

Source: Chant West, 2003: 2; Clare, 2001: 15; Rice, 2003: 26

Other determinants of fund fees include fund size, account size and investment choice. As is shown in Table 1, Column 1, economies of scale were found by Chant West in relation to industry funds, and have been found in that and other studies to apply generally to Australian superannuation funds (Clare and Connor, 2000: 16; Australian evidence surveyed by Coleman, Esho and Wong, 2003: 5). The same finding has been made in relation to equivalent pension and mutual funds overseas

(Rea and Reid, 1998: 12). Economies of scale imply that larger funds are more efficient than smaller funds because they can distribute fixed costs across more members and assets. In effect, members of large funds are better off on average than members of small funds.

Account size also has a significant impact on the level of fees. Most fund fees have a fixed component of at least $50 per week, which represents 2 per cent of a $2,500 account, and only 0.1 per cent of a $50,000 account. Regulations prevent fees from being deducted from accounts with balances below $1,000 to protect small accounts from erosion by fees. However, this comes at the cost of earning zero interest. It is, therefore, only nominal values which are protected. Individuals with accounts below $1,000 receive no compensation for the time value of money, and value diminishes due to inflation. Another issue relating to account size is that most retail funds have concessional rates for higher balances and penalty rates for lower balances. In summary, large account balances are diminished less by administration fees than smaller balances.

Investment choice also has an impact on account fees. Investment in interest bearing assets, such as deposits and bonds, are generally cheaper than investment in shares; domestic assets are cheaper to manage than foreign assets; and passive investment (in funds which match the holdings of indices such as the All Ordinaries) is cheaper than active investment (in funds with managers that evaluate different shares in attempt to get higher than average market returns).

It is conceivable that consumers are rewarded for higher administration cost by higher returns. However, the recent study by Coleman, Esho and Wong (2003) found that the correlation between fund administration cost (measured using management expense ratios) and earnings is actually negative. In effect, lower cost funds outperform higher cost funds. According to the study, consumers of higher cost funds are simply being relieved of a higher proportion of their retirement savings with no compensating benefits.

Superannuation fees *per individual* will also be much higher than average fees *per account* in many cases, because individuals have more than three accounts on average. Having multiple accounts exposes the

individual to multiple fixed fee components and increases the probability of receiving penalty fees associated with low balances.

Finally, erosion of retirement saving due to administration cost does not end at retirement. Accumulations converted into annuities will continue to face administration charges related to personal accounts; indeed at a level typically one per cent higher than ordinary superannuation accounts.

In summary, retirement accumulation in Australian superannuation is severely reduced by fees. Average annual fees are 1.27 per cent of assets, which would reduce accumulation by around 25 per cent. However, with certain types of fund and investment choice, annual asset based fees of 3 per centare not uncommon. This level of fees would reduce accumulation by 50 per cent or more.

Choice, Competition and Administration Cost

The superannuation market today features a significant segment without direct competition between funds for members. Under current arrangements, employees must contribute to a fund connected with their place of employment. The fund is either chosen by their employer or pre-determined by industrial workplace agreements. In neither situation do employees have the right to choose their super fund.

The current Federal government is opposed to these restrictions, and introduced legislation to parliament (initially in 1997) to allow free 'choice of fund'.[3] The legislation was rejected in the upper house by the Labor opposition, minor parties and independents. This reform is about to be implemented[4].

Some leading superannuation researchers support the Government's plans to allow free choice of fund. Drew and Stanford (2003), in

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3 The draft legislation required employers to offer employees a choice of at least five funds (CoA, 1998).

4 On 22 June 2004, the Australian Democrats announced they would support Choice of Fund legislation, prospectively bringing this stalemate to an end.

particular, argue that problems with super such as poor performance and high administration cost are directly related to the lack of choice and resulting lack of competition. They suggest that these problems are principal-agent incentive problems, where various agents (employers, super fund trustees, fund managers, fund employees and consultants) are able to act in their own interests at the expense of the principal (the fund member) due to inappropriately structured incentives. We can explore this proposition with two hypothetical examples.

A strong trend in superannuation is the dismantling of corporate superannuation schemes in which the employer has borne some of the costs of administration, in favour of external provision by a public offer fund. A corporation making this change has the option of outsourcing to providers of various levels of expense. Under current arrangements, the corporation has no direct incentive to choose a low cost fund, because the corporation receives no benefit for high performance, and bears none of the costs of high administration cost. The lack of appropriate incentives on the part of the purchasing entity, explains why corporate employers tend to choose relatively expensive master trusts from retail providers over industry fund products. Master trust assets are currently growing at around 15 per cent per year (Robertson, 17/7/03).

Consider also the hypothetical example of a very small industry fund which has expensive fees per account because it does not benefit from economies of scale. It could continue to operate (largely for the benefit of the fund trustees, management and employees) because the employees in the industry have no choice but to belong to that fund. It is entirely plausible that this is the situation faced by some employees. Industry funds costs are lower than retail funds and close to the industry average according to the Rice (2003) survey. However, fees in smaller industry funds would be higher than average, and the industry average is itself unacceptable because it reduces accumulation by 25 to 28 per cent.

Drew and Stanford do not explore the alternative repercussions of free choice in any detail. It seems, however, that support for a shift to free choice by such economists presupposes a highly idealised counterfactual. For choice of fund reforms to result in low cost superannuation provision, it is necessary that employees move assets to efficient funds; or, that the capacity of members to do so encourages funds to become

more efficient by, for example, merging with other funds to gain economies of scale; *and* that funds pass the benefit of these cost savings on to members. The assumption that this would happen – that choice begets efficiency begets price competition – is axiomatic for many economists but, at least in the case of superannuation and pension products, ignores abundant Australian and foreign evidence to the contrary.

Consumers can exercise choice in a significant portion of the Australian superannuation market. This includes choice over the fund in which most assets accumulated while in previous employment are held. In this portion of the market, funds with public offer status, including retail funds and approved industry funds, compete for the business of individual customers.

For competitive pressure to be applied to providers, consumers must actively manage their superannuation. To achieve optimal performance from their super, consumers must periodically evaluate the performance of their existing fund relative to competitors, and act on this evaluation, consolidating balances in a single account with a low cost provider. However, there is ample evidence that many consumers do not do so. Evidence includes account proliferation, lost accounts and voluntary use of high cost funds.

As discussed above, accounts per worker have risen to over three in recent years. This needlessly exposes consumers to much greater cost than otherwise. There are now at least 4.7 million lost accounts (20 per cent of total accounts) representing $7.3 billion (1.4 per cent of total assets). 52 per cent of accounts are held with high cost, low performance retail funds (at December 2002) (APRA; 2003). The majority of these accounts are opened voluntarily, with cheaper alternatives ignored.

Part of the explanation for this behaviour is that a significant proportion of the consumer population is rather apathetic when it comes to retirement saving. Although super is the largest financial asset of most households, researchers have found that only half of consumers are either 'very' or 'quite' interested in super. Around 10 per cent of consumers with a super account could not name their super fund (Cameron, 2002:5).

Results of this kind should not be surprising, but they highlight a fundamental contradiction between compulsory superannuation and choice. If individuals were not apathetic towards retirement saving, compulsory superannuation would not be necessary. An obvious goal and effect of compulsory superannuation is market participation by many individuals who would otherwise not do so. While compulsory superannuation forces those who are disinterested into the market, choice of fund requires that consumers be interested and active in order that the market behaves efficiently.

Product and pricing complexity, combined with generally low levels of financial literacy, also help to explain inefficient consumer behaviour. Superannuation pricing structures are complex and diverse. Providers can deduct fees at account formation, contribution, on switching investments, on withdrawal or account closure, or simply at regular intervals. Charges at these stages can be dollar-amounts, percentages or a combination of both. Some providers separate the charges for account administration and fund management; others do not. Many funds, especially retail funds, also have additional stepped penalty rates for small accounts and/or stepped discount rates for large accounts. Assuming the fee structure is understood, the actual cost will depend on a range of variables which must be estimated when evaluating funds, such as career contributions and rates of return on a variety of assets (Whitehouse, 2000: 11). A thorough analysis would require a financial model that compared costs over the life of the investment under various scenarios of income, contribution and asset return.

Information available on the level of financial literacy of Australians suggests that most would not know how to begin such an analysis. Ross Clare reports that formal comprehension testing commissioned by ASFA (Australian Superannuation Funds Association) found that most Australians have difficulty understanding fees expressed as percentages (Clare, 2001: 40). This is obviously problematic, as evaluating super charges requires not only understanding of percentages, but an ability to compare percentage fees levied on assets to those levied on contributions. Another survey has found that during the recent period of negative investment returns, attitudes to super were not as hostile as industry insiders expected, partly because some members misunderstood

statements, confusing accumulation due to contributions with positive investment returns (Cameron, 2002:10). A recent survey by Roy Morgan Research found that 55 per cent of fund members knew little or nothing about the fees and charges that apply to superannuation (RMR, 2003:7).

An additional complication for consumers navigating this complex market is inadequate disclosure. Some fees related to asset management, such as stamp duty and brokerage fees, are not always made explicit to the consumer, being deducted instead from gross returns (Clare, 2001: 7-8). *These are fundamental omissions because net returns are essentially what is being purchased and administration cost is the price paid for those returns.* If elements of the cost are hidden, consumers can accurately calculate neither the value of the product they are purchasing, nor the price they are paying for it. Inconsistency in levels of disclosure between providers will encourage consumers to use funds which conceal expenses and therefore appear cheaper than they really are.

It is not surprising that many consumers in this market seek advice. Financial planners are an important source of advice. Unfortunately, advice from most financial planners cannot be considered objective. Most financial planners in Australia are remunerated not by direct fees, but via commissions on specific financial products, including superannuation funds. Planners receive up-front commissions of between 1.5 and 2.5 per cent (out of the 5 per cent contribution charge typical in a retail fund) and annual trailing fees on assets under management of around 0.6 per cent (Bruining, 26/6/2002). ASIC (Australian Securities and Investments Commission) suggests that 1.5 to 2.5 per cent of assets invested is what an investor can expect to pay a financial planner for investment in general (ASIC, 2002: 3).

Rice (2003) provides a breakdown of periodic fees that is consistent with these figures (see Table 2). The breakdown implies that financial planners' trailing fees represent *more than a quarter* of ongoing administration charges in the retail sector. These charges are equivalent, coincidentally, to the entire average administration fee of public sector super funds.

A recent survey into the quality of financial planning by the Australian Securities and Investment Commission (ASIC) focussed doubts

concerning objectivity. 70 per cent of surveyed financial planners *had an ownership link* to offered products (ASIC, 2003: 6). ASIC also noted a number of general weaknesses in financial planning, including tendencies to recommend higher cost investments, and recommend selling existing investments without appropriate explanation (ASIC, 2003: 5). The finance industry recognises that offering higher rates of commissions to planners is an effective strategy when launching new exotic investment products (Bruining, 26/6/2002). This tendency underscores the failure of competition to deliver cost effective superannuation. While such products offer lower performance, the marketing strategy is effective because of selective promotion by financial planners, and the complexities associated with investment evaluation which obscure the cost to the consumer.

Table 2. Breakdown of Periodic Charges in Retail Funds

Element of Cost	Asset-based Fee
Administration	0.93%
Investment	0.70%
Financial Advice	0.60%
Total	**2.23%**

Source: Rice, 2003:22

Another source of information is product advertising. However, product advertising adds cost and provides only promotional information which may be misleading. Research in the UK by the Financial Services Authority suggests that high cost funds are able to represent themselves in marketing material as low cost funds, thereby attracting consumers seeking the latter kind of product (James, 2000: 8). Given the complexity of products and low levels of financial literacy in Australia, this is presumably commonplace here also.

There is no evidence in the market today that choice of fund will lead to effective price competition. The situation can be summarised in three points. First, personal account based systems are inherently expensive. Superannuation assets are held in trust for members. Each cash contribution to a fund is exchanged for other financial assets according to specified investment options. Superannuation fund management

accordingly involves continual financial transactions between and within asset types as demands from members for given assets rise and fall. A variety of information must be kept in relation to each account, including contributions, investment options, investment returns, taxation and other deductions. The member is periodically supplied with information concerning fund performance. The member can change investment options and can at certain times, such as when leaving an employer, change provider. These system characteristics carry unavoidable costs. Even an efficient fund would have a fee floor below which it could not offer service.

Second, competition carries additional costs. This is apparent from analysis of the partial competition that has developed since industry funds have been able to gain public-offer status and compete against retail funds. It was hoped that this reform would put price pressure on the retail funds. In fact, it has put cost pressure on the industry funds. Even though industry funds are lower cost and higher performance than retail funds, they have had to change product offerings, invest in new IT, and, most importantly, develop and maintain marketing exposure to compete against the retail firms (Hely, 1999: 20; Mace, 1999: 46). An ongoing challenge for industry funds is how to gain (or even protect) market share without being promoted by financial planners or using costly mass media advertising.

Finally, as discussed at length above, choice simply does not result in price competition. Many consumers are either too disinterested or confused by complex products and pricing (and misleading advice) to make efficient selections. The result is account proliferation, lost accounts, and a *majority* of accounts being in personal retail funds, which offer the highest cost and lowest performance.

Privately operated funds do not have meaningful incentives to reduce fees. Ironically, this does not mean there are not incentives for them to operate efficiently. Two important trends in superannuation are mergers and outsourcing of administrative and other services, both of which take advantage of economies of scale.

In the 8 years to June 2003, the number of ‘non-small’ funds fell from 5,001 to 2,290 (APRA, 2003). And many of the remaining funds

outsource tasks to a highly concentrated service provision industry. In fund management, the top ten operators hold around 63 per cent of the market. In asset consulting, the major five hold around 75 per cent of the market. In administration, two major players – AAS (an AMP subsidiary) and Jacques Martin Industry – dominate the industry fund sector with a combined market share of 83 per cent (Clare and Connor, 2000: 18-19).

However, despite these developments – which have presumably made superannuation more efficient – fees over this period have remained broadly constant as a proportion of assets. This period has included legislated growth in contributions and rises in asset values to record levels, which implies also that fee income has grown rapidly. In summary, fee income has continued to rise despite funds becoming moire efficient due to mergers, outsourcing and legislated growth, along with technological advances such as internet information collection and distribution. In effect, no benefit from these efficiencies have been passed on to retirement savers.

Alternate Directions for Reform

The weight of evidence from the current partially competitive Australian superannuation market suggests that free choice of fund would compound rather than address the negative impact of administration fees on retirement accumulation. Indeed, a number of reforms are urgently required to reduce administration fees given the *current level of choice*. For the long term, international research suggests that more effective price competition may be achieved through public auction of a strictly limited number of fund licenses on a lowest fee wins basis. This ‘competition for the market’ rather than ‘competition in the market’ model[5] has been adopted by the Swedish in the private funded pension component of their revamped pension system.

5 Models of these kinds have been used to subsidise unprofitable transport or telephony services in regional areas.

Some reforms are obviously and immediately needed to reduce unnecessary fees. Account proliferation can and should be reduced immediately through automatic account consolidation. The ALP opposition has developed a policy to address this problem. It would be operated by the Australia Taxation Office (ATO) using Tax File Numbers which are identifying information on most lost superannuation accounts.

Fee structures must also be streamlined. The current government has emphasised effective disclosure as a method of promoting efficient market equilibrium. Disclosure is a necessary but inadequate condition for price competition. Knowing what all the fees are and the impact over lifetime fund membership is essential. However, when fee structures can consist of a unique combination of up to seven distinct components, no method of display or arrangement of the fees will enable direct comparison without sophisticated modelling techniques. ASIC's recent failed attempt to facilitate effective comparison with a standard reporting display (see, for detail, Ramsay, 2002) will not be substantially bettered until the underlying fee structures are simplified.

Every fund should be compelled to levy a single annual asset based fee on each product, and provide an estimated lifetime dollar impact based on a standardised set of assumptions concerning lifetime income, contribution, returns and inflation. This will enable effective direct dollar-value comparisons for those who struggle to understand percentages. Consultation between ASFA (predominantly representing industry funds) and ISFA (representing retail funds) has been requested by government in order to come to an agreement on disclosure (Kohler, 31/3/2004). Not surprisingly, retail funds vehemently oppose a level of disclosure which would remove the veil of secrecy which supports the majority market share of their high cost products.

A public information service ranking all public offer funds according to fee level would facilitate direct, objective comparison. Claims of higher returns on exotic investment products cannot be substantiated and should be prohibited. Finally, commission based selling of superannuation products represents a direct subtraction of value. There seems to be no reason why this distribution channel should not be prohibited.

These reforms are essential to remove the grossest methods of manipulation of consumers in the superannuation market. Movement away from a consumer market altogether, while still allowing choice, holds further promise. Sweden offers a compelling example of an OECD country that has structured the private funded component of its pension system in a manner that offers choice while minimising costs.

There are two key elements that deliver cost control. First, account administration is handled by a single government agency. Account proliferation is consequently avoided and administrative economies of scale are maximised. Second, investment activities are handled by a limited number of licensed private fund managers. Licenses are auctioned on a 'lowest fees wins' basis. The price of these services are therefore negotiated in a structured, transparent, monopsonistic market which guarantees price competition. Consumers are presented with a limited range of investment options available through these managers. Researchers from the World Bank, an organisation which traditionally claims technical advantages associated with free financial markets, have recently found the Swedish institutional market to be substantially more efficient than consumer markets, with an annual cost of around 0.7 per cent of assets (James, Smalhout and Vittas, 2001).

Conclusion

Current average levels of administration fees reduce Australian superannuation accumulation at retirement by around 25 per cent. Some leading researchers argue that high fees are caused by a lack of choice and competition, which allows agency incentive issues to go unchecked.

However, there is partial competition in the Australian market currently – for assets accumulated while in previous employment. Evidence from this market segment provides no indication that full choice would lead to price competition. Many consumers are apathetic about retirement saving (which is the reason compulsory superannuation exists) and incapable of conducting the complicated analyses necessary to compare alternate providers and products. Commission based financial planners and product marketing convince consumers to purchase high cost

products. As a result of these and other factors, efficiencies gained through increasing economies of scale and improved technology have not been passed on to retirement savers.

Increased choice would compound rather than alleviate existing problems. Indeed, reforms are urgently required to achieve reasonable outcomes from the current level of choice. Suggested reforms include automatic account consolidation, full disclosure, complete fee simplification, an official list of public offer funds by cost, and prohibition of commission based selling on superannuation products. Some of these reforms are being considered by the current Federal government or are proposed by the Opposition.

Still lower cost would be achieved through transition to an institutional market in which administration is centralised, and limited fund management licenses are auctioned on a lowest cost wins basis. Sweden provides an example of such a system.

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