

www.SuperSystemReview.gov.au

Super: the case for microeconomic reform

An address to The Committee for Economic Development of
Australia (CEDA)

26 May 2010 – Four Seasons Hotel, Sydney

Jeremy Cooper, Chair, Super System Review

Introduction

1. Thanks Michael. I should say that we have been grateful for the three valuable submissions that MLC has made to the Review so far.
2. As a lawyer about to speak to you on microeconomic reform, I caution you about Bentley's second Law of Economics: The only thing more dangerous than an economist is an amateur economist!
3. How many economists does it take to change a light bulb? Eight. One to change the bulb and seven to hold other things constant. Chicago School economists would answer that the market would replace the light bulb if it needed replacing.
4. Jokes aside, I am very pleased to have the opportunity to speak at a CEDA event on the cusp of completion of this Review. There are few issues that fit CEDA's national, social and economic agenda so neatly as superannuation.

The case for microeconomic reform

5. Today, I am going to spell out the case for microeconomic reform of the superannuation system. In a nutshell, the system is not operating efficiently enough and members are entitled to better.
6. This is not a new theme. Indeed, some of you might recall Vince Fitzgerald's paper for CEDA in 1996 *An Assessment of Current Superannuation Arrangements* where Vince asked the very question: *is the system efficient? Is it simple and easy to comply with? Does it avoid economic distortion and distortion to choice?*
7. Super in Australia is a concept built on government intervention. But, having taken the huge step of having all employees compulsorily contribute to the system, the government handed more or less everything over to the private sector to provide the moving parts, to do the investing, the administration and so on.

8. In doing this, the government naturally thought carefully about regulation, but the focus was primarily on prudential safety. This was back in the early 90s when the landscape was dominated by defined benefit (DB) funds. DB funds quite rightly need that sort of regulation, but the defined contribution (DC) super fund, that is a natural consequence of compulsory superannuation, is a different creature.
9. In a DC super fund, the risks are primarily: fraud; incompetence of actors and agents; and other operational risks which APRA does a very good job in regulating. The principal risk - the exposure to market-linked assets - is assumed entirely by the members. Something we have had a very clear reminder of in recent times.
10. What has been almost entirely missing in this regulatory equation is measurement and regulation of the efficiency of the system: what does it deliver and at what cost? And this was less an oversight than a belief that in handing over the workings to the private sector, competition – especially with the introduction of ‘choice of fund’ - would iron out inefficiencies, force innovation and drive poor performers out of business. That sounds right. Markets don’t need governments chasing after them to make them efficient do they?

Is the super system competitive?

11. This was indeed the thinking. In 1997, the Wallis committee said that it expected funds management and superannuation to become economically efficient over time due to downward pressures on costs exerted through market competition.¹
12. However, the idea that we can rely on market forces in super to solve problems has proved to be somewhat optimistic. We know that markets for tangible goods efficiently allocate resources, shape products and discover prices.
13. A current example would be the market for e-readers (ie a hand-held device on which books can be read). The market will find a

price at which a sufficient number of people will be prepared to make the change and read books in this new way. Screen size, operability, memory size, availability of titles, brand loyalties and so on will be at play. Interested consumers will pick up an e-reader and see whether they like using one. One of their friends will talk about the one they have just bought.

14. Superannuation is different. What is the actual product and where is it? How do you distinguish one product from another? Is super an ongoing experience or merely what you get on retirement? It is not accessible to consumers in the ordinary sense and the costs in the form of fees (and even rises and falls in capital value) are not directly felt by most members. Super is a very different product when it comes to applying the standard notions that apply in markets for tangible goods or what might be called 'direct services'. The problem with super is that it is both intangible and remote; a very long term and quite uncertain promise. In fact, it would be hard to think of a product less suited for competition.
15. As it happens, competition in the market for super at the consumer level (ie between rival funds competing for the business of a new member) is relatively weak. While the many players in super give the appearance of quite vigorous competition at some levels, it does not occur at the member level.

Why is competition difficult in super?

16. As we all know, unless you are self-employed, super is compulsory. This has quite a pronounced impact on competitive forces. There are very few products where consumers can't vote with their feet and just not buy at all. In super, you have to be in one fund or other and, when to most consumers, it all looks much the same, this can have a dampening effect on competition.
17. There are some other unique things about super that make normal consumer demand-led competition more difficult:

- **Boring:** First, super is pretty boring. A lot of people are just not interested in it, particularly when they are young. They start to get interested closer to retirement and so just won't respond to competitive behaviour on the part of funds until that time (if at all). This was aptly captured by one of our focus group members who said:
 - “even the name superannuation is boring; it sounds like something your mum and dad would talk about;
- **No real choice:** Often a member doesn't choose the fund to which they belong. Being so connected with employment, new employees typically just agree to join their employer's default fund. This might mean that suppliers (ie super funds and wealth managers) compete with each other to win the favour of large employers to provide their default fund, but cannot effectively win business directly from consumers;
- **Remoteness of costs:** Compulsory contributions don't come directly out of members' pockets (although they are regarded as deferred wages) and nor do the fees and other costs charged by the fund (at least not until members retire). This makes people much less price aware and much less likely to make a decision based on price or cost;
- **Complexity:** Super is inherently complex and many consumers do not feel confident making decisions about it. When you're forced by someone else to buy a product which is simultaneously complex and boring, it's quite a rational thing to shrug your shoulders and walk away until you REALLY need to pay attention. As one of our focus group participants put it:
 - “I shake my head, keep working and hope for the best”;
- **Opacity of information:** Even if members are engaged up to a point, there is a lack of contestability at consumer level

because of opacity of information about fees and fund performance;

- **Friction:** Lastly, even if someone is interested in switching funds, often the paperwork and other 'frictions' in changing funds become too big a disincentive and they give up. Again, one young member from one of our focus groups recounted how she had to pay a \$50 fee to access and transfer the \$80 in her account.

18. That said, reasonably strong competition occurs at the distribution level – ie suppliers compete with each other for the ownership of or linkages with dealer groups who distribute fund product to consumers, or at the wholesale funds management level, or to be nominated under particular industrial award, but not at the consumer level. However that doesn't necessarily mean that members always get the benefit of that competition. It depends on the business model and the structure of the value chain. The value chain between the product-maker and the end consumer is sometimes complex and the various participants constantly tug on each other's margins.

Prices are not coming down

19. The corporate master trust market is one where it is sometimes argued that the benefit of rigorous competition does flow directly to members. Fund offerings marketed to employers compete primarily on the basis of cost to members. But, the critical distinction here is that the 'customer' making the buying decisions is doing so in bulk and is generally a sophisticated buyer; often putting the process out to tender advised by a tender consultant. One way or another they manage to get prices down!
20. But, even in this area, claims about price reductions need to be put under closer scrutiny. It was put to the Review that estimated average fees in this sector in 2008 had come down substantially from levels earlier in the decade (2002). However, this overlooks the considerable growth in actual dollar fees payable over that

period due to underlying asset growth. Average large corporate master trust fees fell by 0.45 percentage points from 1.24 per cent in 2002 to 0.79 per cent in 2008.² That is, a fall of 36.29 per cent in the percentage rate.

21. However, Rice Warner figures also show that the funds under management in the corporate sector grew by roughly 93 per cent over that same period. What this means is that, in nominal dollar terms, fees went up, not down, by over 22 per cent. Now, let's be fair and put that in real terms. One option would be to deflate fees by the combination of growth in the number of members and general prices growth. For argument's sake, let's say that is 5 per cent a year. Over four years, that provides a deflator of 21.55 per cent, ie very close to the 22 per cent increase in dollar fees. So, even in this sector, fees haven't gone anywhere; they have stayed about the same.
22. Just a couple of points of clarification. Fees have certainly come down from the 1980s when outrageous contribution fees and commissions were charged, so there has been a large improvement since those times. However, that was before the advent of compulsion, so distribution costs would have been much higher then. We are also probably paying lower fees than some comparable countries, so it is not all bad news. Also, there are signs of overall fees reducing in the retail sector, admittedly from a very high base and there seems to be an overall consensus that members are getting better prices for insurance.

Inefficient back office

23. The anecdotes about the nightmare that is the back office of super are legion: contributions delivered in a pizza box or bags of foreign currency without any details of who it is for. Some of them are no doubt apocryphal, but it is universally agreed that there is a problem and it needs fixing.
24. There is widespread consensus in the industry that the lack of a unique member identifier, which can be used to link accounts with

contributions, and to identify multiple accounts held by the same person, is a significant impediment to major cost savings in the industry.

25. Earlier this year, the Panel suggested that tax file numbers be used for member matching within super to reduce costs and so maximise member retirement benefits. We now know that this had already been recommended by the Henry Review in its report of late last year. The support of the Privacy Commissioner for this proposition has also been welcome.

e-commerce

26. Another area ripe for reaping efficiency gains is the use of e-commerce – the linked electronic transmission of data and money. However, the lack of common data standards, the lack of early adopter benefits, the lack of incentive for employers (and especially small employers) to participate and the narrow profit margins for administrators have hindered progress so far.
27. Employer take-up of electronic transactions for super is a particular impediment. Sixty one per cent of businesses are aware that all their superannuation funds allow electronic payments. However, fully 38 per cent of businesses use only cheques and 22 per cent use a combination of cheques and electronic payments. Recent data provided to the Review shows that there is a very high take up of e-commerce by members making voluntary after-tax contributions. It is a question of how we incentivise employers to follow suit.

Economics of the back office

28. It is also fair to say that the economics of the back office of super have become dysfunctional. Two things have happened. Funds seem to have driven prices so low that the administrators are only barely viable at those prices. This is actually counter-productive and puts the whole system at risk. Secondly, because there are nearly 20 million more member accounts than there should be,

the prices charged for each account are out of alignment with what it actually costs to manage an active member account. Many active members who currently have only one account (and not the industry average of about three) are probably being charged administration fees that are substantially below cost. This creates a number of unhelpful distortions.

29. Let's imagine that every bank customer who had a normal card-linked savings account also had at least two other similar accounts on which they were paying similar fees, but which they didn't really need. They would like to close the other accounts, but it was too complicated. That's the current state of play in super.
30. How did this situation get to be such a big problem? There are many explanations, but a key one relates to the regulatory framework.

Regulating for efficiency

31. The Review Panel is convinced that the super industry needs a regulator to apply pressure to deliver the best returns to members as efficiently as possible. In a compulsory retirement saving system, trustees need to be fully accountable for the overall cost of creating those returns. The system has shown that it needs regulatory pressure to create the transparency, which creates the comparability which, in turn, creates accountability for outcomes.
32. Leaving the industry to its own devices is simply not going to deliver the necessary improvement in member outcomes.

Lack of transparency – too many layers

33. The lack of transparency on fees is a problem. The structure of many funds is another problem. There are situations where a layered structure of related parties provides opportunities for collecting undisclosed fees. As actual costs are typically only reported at the top layer of a multi-layered structure, the audited

financial accounting data are accurate and reliable as far as they go, but irrelevant for most stakeholders.

34. For instance, some large funds could, in theory, report zero investment management costs – but that is because all those costs (and associated profits) are incurred in an associated investment manager, and netted off before the investment return is provided to the fund. Indicative fees and costs in product disclosure statements cover more varieties of costs, but are too vague and imprecise to be truly informative.
35. But that doesn't mean these costs don't impact on the investment returns earned by members, or on the profit margins earned by service providers. Of course they do. They represent a leakage out of the system and make it harder for super fund members to achieve the account balances they need to retire comfortably.
36. That said, the Panel does not believe that regulating fees is the way to go. Rather, the Panel is favouring a combination of measures designed to make the system more transparent and accountable, as well as making the data more reliable, should be effective in increasing the price-competitiveness of the industry.

The Review response

37. The Panel's final report aims to address these issues in a variety of ways. I will discuss two now.

MySuper

38. The first is MySuper. MySuper may be viewed as a new type of product, but it is really a return to the principle that compulsory superannuation should work well for all members, not just those with the time and financial literacy to make well-informed choices or the financial wherewithal to pay for advice. It has to work for everyone.
39. Currently, the vast majority, roughly 80 per cent, of Australian workers are invested in the default option in their current fund.

Are they there because they want to be, or simply because that was where they were put? No one knows for sure, but in one sense, it doesn't matter. The Panel has chosen to include both these groups of members within the scope of MySuper because a well-managed, but cost-effective, product is in the best interests of both types of member. MySuper is specifically designed to cater to the large number of Australians who would prefer to delegate the task of designing and maintaining an investment strategy for their super to someone else. Again, this message came out strongly in the focus group discussions – not everyone wants to have to make all the decisions for themselves. Many want someone with relevant expertise to make key decisions for them, at least until that time when their account balances and their proximity to retirement bring superannuation onto their radar.

40. It is important not to get too focused on MySuper, though. The Panel is committed to ensuring that those members who want to make choices can do so. So-called 'choice' products remain an important component of the superannuation sector, even though they are excluded from the specific rules proposed for MySuper. This is a key part of the choice architecture we have proposed. Critics who suggest that we are 'dumbing-down' superannuation are missing the point. For those who want to take command of their superannuation, to make choices and to tailor their strategies for their own needs, will have that ability. And the enhancements we are recommending to back office efficiency will make that an even more compelling opportunity than it is now.
41. Similarly, many people will want take all the responsibility for their superannuation strategies, so the SMSF sector will continue to be right for many people.

Scale

42. One of the key concepts in MySuper is scale. Over time, particularly with superannuation trustee licensing in 2006, there has been significant industry consolidation. It is easy to forget that

there were almost 5,000 super funds regulated by the Insurance and Superannuation Commission in June 1996. We are now down to less than 500; 463 in June 2009, to be precise. However, the Review Panel believes this is still not enough consolidation.

43. Realising that we would need empirical data to back up our proposition that scale really matters in super, we commissioned Deloitte to do a report on the cost savings that could be achieved were our MySuper recommendation to be implemented.³
44. Specifically, the Deloitte report showed that a member with an account balance of only \$25,000 in super would be paying around \$200 a year,⁴ and in some cases less than half that, in total costs under the MySuper proposals.

Table 1: Potential total costs per MySuper member

Estimated total costs for MySuper products of varying sizes (all costs expressed as basis points) Investment costs + Operating costs (incl. intra-fund advice)							
Fund size: \$millions	<100	500	1,000	2,000	5,000	10,000	>20,000
Passive investment							
Balanced portfolio	136	104	80	60	46	38	32
Conservative portfolio	129	98	76	58	45	37	32
Active investment (excluding alternatives)							
Balanced portfolio	166	136	111	94	83	70	60
Conservative portfolio	151	123	97	80	70	59	49
Active investment (including alternatives)							
Balanced portfolio		149	121	104	89	77	66
Conservative portfolio		134	107	89	76	64	54

45. The Deloitte Report shows once again the power of economies of scale in reducing per member investment and operating costs. But, there are impediments to achieving that scale. For example, it has been suggested that some mergers have not occurred because the board cannot agree on the name of the fund or the number of trustee directors. More seriously though, there are

systems issues, taxation issues and legal technicalities that can hinder efficient mergers and the Review is looking at solutions to some of these.

SuperStream

46. The Panel's SuperStream proposals will complement MySuper, further driving down overall costs.
47. SuperStream is a package of proposals designed to bring the back office of super into the 21st Century.
48. It has been estimated that the Australian superannuation industry processes more than 100 million transactions annually, which cost over \$3.5 billion annually to process. These include member support activities (\$1 billion), contribution management (\$1.25 billion), reporting (\$250 million), and benefit payment services (\$1 billion).
49. The potential gains to the system from improved efficiency in contribution management are demonstrated by the estimate that 'straight-through' electronic processing of correctly provided member and financial data is 5 cents, and perhaps less, per transaction.
50. Some industry participants have pointed to potential cost savings from reforms along the lines of SuperStream of up to \$1 billion a year. Even if it were half this amount, it would represent a substantial boost to retirement savings.

The bottom line

51. The Review has been doggedly focusing on efficiency; particularly lowering costs. Many have asked: "Why are they so focused on costs? Surely, it's more about the net investment return at the end of the day?" This is the argument that high fees can be justified where the fund achieves higher performance. However, there was no data provided to the Panel that supported the assertion that higher costs (for an equivalent asset allocation and

risk exposure) correlated in any meaningful way with long term investment returns. In fact, most research shows the reverse.⁵

52. The point is ably made by a group of 15 eminent US economists⁶ who comprise the 'Squam Lake Working Group on Financial Regulation':

*"High-fee funds argue that their fees are justified by superior performance. A large body of academic research challenges that argument. On average, high fees are just a drain to investors. While some investors might gain by selecting successful high-fee funds, the negative sum nature of the process implies that other investors might lose even more."*⁷

53. A fund charging a member total fees of 2 per cent⁸ a year and achieving a 5 per cent return after tax⁹ is actually eating into a staggering 40 per cent of members' after tax returns. That's what fees do in super.
54. A dollar saved in fees or costs is a dollar that goes straight into members' retirement accounts. That dollar compounds with investment returns over time. Fees and costs matter.¹⁰

Conclusion

55. To end, I would just like to bring us back to why we have a superannuation system in the first place. In 1992, when John Dawkins was introducing the SIS legislation to Parliament, he said:

*"No investment is more special than superannuation. No investment is more critical in providing retirement income for an increasingly ageing population."*¹¹

56. Efficiency matters in superannuation. There is no superannuation tooth fairy. Failing to make our system more efficient will cost all of us dearly.

ENDNOTES

-
- ¹ 1997, Financial System Inquiry Final Report, pp 214 and 220.
- ² Rice Warner Actuaries, 'Superannuation Fees Report 2008', December 2008.
- ³ <www.supersystemreview.gov.au/content/downloads/mysuper_paper/Deloitte_report.pdf>
- ⁴ 80 basis points.
- ⁵ Bogle, J.(2005), The relentless rules of humble arithmetic, Financial Analysts Journal, November/December 2005, pp.22-35; Sharpe, W. (1991), The arithmetic of active management, Financial Analysts Journal, January-February, pp. 7-9; Sy W (2009), Towards a national default option for low-cost superannuation, Accounting Research Journal Vol. 22 No. 1, pp.46-67.
- ⁶ Including Ken French, Frederic Mishkin and Robert Shiller.
- ⁷ July 2009 Working Paper: *Regulation of Retirement Saving* at<www.squamlakegroup.org>.
- ⁸ Rice Warner Actuaries, 'Superannuation Fees Report 2008', December 2008.
- ⁹ APRA, 'Statistics – Annual Superannuation Bulletin', 10 February 2010.
- ¹⁰ Burton Malkiel, Foreword to *The Mutual Fund Industry, Competition and Investor Welfare*, Hubbard et al, 2010, Columbia University Press ISBN 978-0-231-15182-5. "...in my own research, I have found that total expenses, including both management costs and the implicit costs of portfolio turnover, are the most important determinants of investor returns."
- ¹¹ John Dawkins, *Strengthening Super Security. New Prudential Arrangements for Superannuation*, (AGP, Canberra, 1992), at iii.