Superannuation Fees

Financial System Inquiry

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1. Executive Summary

1.1 Introduction

The superannuation industry has grown spectacularly over the last decade. Over the period from 30 June 2004 to 30 June 2013 the industry has grown from $625 billion in funds under management to $1,617 billion, an annual compound growth rate of 11.1% p.a.

Over this same period, fees within the industry (excluding SMSFs and SAFs) have fallen only 0.20% when expressed as a percentage of funds under management, from 1.40% in 2004 to 1.20% in 2013. This has occurred despite many commentators expecting the decline in fees to occur at a much faster rate.

Total superannuation fees were about $16.9 billion in the 2013 financial year.

This report examines the potential reasons by looking at the potential impact that various factors may have had on fees and fund expenses over the past decade. The report addresses:

- Changes in fees over 10 years.
- A breakdown of fees into components (operating expenses, investment expenses and margins of fees over costs) and sub-components.
- An attribution analysis showing causes for increases/decreases in fees over the last decade, including:
  - market forces
  - impact of regulatory change
  - factors affecting operational expenses
  - factors affecting investment expenses.

We have included a copy of the report prepared for the FSC on superannuation fees for the 2013 financial year. This provides background to the fees charged in each of the industry segments (industry funds, public sector funds, retail funds, corporate funds and self-managed superannuation funds [SMSF]).

1.2 Results

Our analysis finds that numerous factors have influenced fees. Some of these factors have put downward pressure on fees in the order of 46 basis points (bps), other factors push fees up, estimated at 34 bps.

The biggest drivers of fees have been:

- increase in size of average balances (-19 bps)
- competitive pressures reducing margins (-15 bps)
- scale benefits reducing operational costs as a percentage of assets (-14 bps)
- larger investment mandates (-9 bps)
- higher direct management fees following the GFC (+8 bps)

- An outline of all the factors examined that were deemed to have a significant (> 1 bps) impact on fees is given in Table 1.

Table 1. Attribution analysis

	Driver	Change in fees (bps)
Market forces	Margins	-15
	Market shares	1
	Corporates shift to MEFs	-3
	Pensions	1
Operating expenses	Marketing	5
	Reform implementation	4
	Advice	2
	Average balances	-19
	Scale benefits	-14
Investment expenses	Larger mandates	-9
	Higher direct management costs after GFC	8
	Asset allocation	3
	MDI	2
	higher performance fees in 2013	2
Other	Interaction & others	11
Total		**-20**

1.3 Current trends

In the near future, we expect fees to converge on **100 bps.** This prediction is driven by a number of factors:

- the introduction of lower cost MySuper products
- increased efficiencies in administration arising from e-Commerce (SuperStream)
- exiting a period of high regulatory reform which pushed up short term costs
- increased passive investing
- shift of legacy products into MySuper (2017)
- end of grandfathering of Accrued Default Amounts (including product commissions).

This report was prepared and peer reviewed for the Financial Systems Inquiry by the following consultants.

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2. Background

2.1 Superannuation fees

The FSI is interested in why superannuation fees have not reduced significantly over the last ten years despite the huge increase in the assets in the system during that period.

This report sets out our findings after conducting an attribution analysis of the system over the period from 2004 to 2013. Throughout the report, fees and expenses have been measured year on year as a percentage of funds under management.

We have addressed in this report:

- Changes in fees over 10 years
  - Showing fees separately by superannuation segment (industry, corporate, public sector and retail funds).
  - We have shown fees in SMSFs as an aside, however, this report almost exclusively focuses on fees in APRA regulated and regulation exempt funds.
- A breakdown of fees into components (operating expenses, investment expenses and margins of fees over costs) and sub-components.
- An attribution analysis showing causes for increases/decreases in fees over the last decade, including:
  - market forces
  - factors affecting operational expenses
  - factors affecting investment expenses.

2.2 Method

Superannuation Fees are complicated and are influenced by a number of interacting factors. In this report, when referencing an 'attribution analysis' of fees we have not used a formal 'analysis of surplus' model which looks at the impact on modelled fees by changing parameters one at a time. Rather, this analysis is based on an analysis of the many factors which drive fees and a best estimate of the significance of those factors given the data that is available.

In many instances, we have leveraged our existing research and knowledge from our consulting activities, as well as publicly available data published by APRA and the ATO. Key pieces of research used to support this report include:

- *Superannuation Market Projections 2004 – 2013 (Rice Warner)*
- *FSC Superannuation Fees 2004, 2006, 2008, 2010, 2011 and 2013 (Rice Warner)*
- *Superannuation Expense Benchmarking Research 2010, 2011 and 2012 (Rice Warner)*
- *APRA Fund Level Profiles and Performance*
- *APRA Annual Superannuation Bulletin.*

3. Fees

3.1 Background

Rice Warner has measured superannuation fees since 1999 for the FSC. These reports have usually been published biennially allowing us to show longitudinal trends.

We define superannuation fees to be the amounts charged to members for the costs of managing the fund. Several items are excluded, including:

- Taxes and insurance premiums.
- Fee subsidies made by employers (of large companies) and not charged to the fund.
- Fees for personal financial advice which are paid directly by members and not taken out of fund fees.
- Tax credits for deductions on fees and insurance premiums which some funds retain in a separate tax reserve rather than crediting back to individual members.

We have added in the investment/interest margin on guaranteed products (term deposits, cash and annuities) for the retail and SMSF sectors.

We have separated fees into three major components:

- Operating fees – within the industry these are typically referred to as administration fees. In the retail sector, they often include platform fees; platforms being portals set up for multiple investments, which provide consolidated reporting to a member and their adviser.
- Financial advice – this is the component of overall fees required to cover the costs of providing advice to members. In the retail sector, these fees are usually deducted from member accounts to finance commissions paid by the product provider; in other sectors they cover the costs of providing advice (e.g. intra-fund advice) directly to the members or the cost of advice services provided by a third party.
- Investment management – this is the cost of investing and includes the costs of external fund managers, asset consultants and in-house investment teams.

The introduction of MySuper from 1 July 2013 removed commissions from superannuation products. This change is not reflected in the fees charged in the 2013FY, but we measure the reduction separately to show the impact of the change.

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3.2 Fees in 2013

We estimate that the overall fees for the whole superannuation industry, expressed as a percentage of assets, averaged 1.12% (or 112 bps for the year to 30 June 2013 on assets of $1,617 billion).

Our estimate for the year to June 2011 was 1.20% (on assets of $1,342 billion).

A breakdown of superannuation fees into components (operating, investment and advice) is given in Table 2.

Table 2. Fees 2013 (Fees by superannuation segment – Year to 30 June 2013)

Sector	Segment	Operating	Investment management	Operating & investment management*	Advice	Total Fees*
		(bps)				
Wholesale	Corporate	26	49	76	2	78
	Corporate Super Master Trust (large)	22	45	67	19	86
	Industry	41	62	103	4	107
	Public Sector	20	52	72	4	76
Retail	Corporate Super Master Trust (medium)	58	48	106	24	130
	Corporate Super Master Trust (small)	104	50	153	16	169
	Personal Superannuation	84	53	137	36	173
	Retail Retirement Income	55	62	117	54	171
	Retirement Savings Accounts	60	10	70	-	70
	Eligible Rollover Funds	197	46	243	-	243
Small funds	Self-Managed Super Funds	26	54	80	15	95
Total		**40**	**55**	**95**	**17**	**112**

* Components may not add up to totals due to rounding.

Corporate super master trusts have been separated by size into:

- Large funds – sub-plan size above $5 million
- Medium funds – sub-plan size between $2 million and $5 million
- Small funds – sub-plan size below $2 million.

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3.3 Ten years of superannuation fees

We note that the total fee rate for 2013 is 18 bps lower than the 2004 expense rate. The decrease in fees is considered by some commentators to be modest. Fund consolidations have resulted in increased scale and lower fees across the industry. However, other offsetting factors have prevented fees from falling as far as they could. These causes are discussed later in this report.

A summary of fee rates over the last decade is set out in Table 3.

Table 3. Total fee rate by superannuation segment

Segment	Fee rate (bps)									
	2004	2005*	2006	2007*	2008	2009*	2010	2011	2012*	2013
Corporate	75	77	78	76	73	77	80	79	79	78
Commercial	206	198	189	185	181	183	185	170	164	157
Industry	118	116	113	110	107	117	126	113	110	107
Public Sector	66	68	70	70	69	75	81	82	79	76
Total excluding small funds	**140**	**142**	**139**	**127**	**132**	**136**	**140**	**129**	**124**	**120**
Self-managed Super Funds	101	94	87	93	98	100	101	100	98	95
Total	**130**	**128**	**126**	**124**	**121**	**124**	**127**	**120**	**116**	**112**

* These figures have been estimated by interpolating between years for which data is available.

4. Expenses

4.1 Total expenses

Since 2010, Rice Warner has published its *Superannuation Expense Benchmarking Report,* which looks at the costs of managing all facets of a superannuation fund. This report is based on survey data collected from a participating set of funds, supplemented by publicly-available APRA data from the annual *Fund Level Profiles and Performance* statistics.

From the available data we have calculated a summary of expenses as a percentage of the net assets of funds over the last decade as set out in Table 4.

Table 4. Total expenses rate (bps) over 10 years

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
	(bps)									
Total Operating Expenses	54	53	49	47	45	46	45	44	44	45
Total Investment management Expenses	55	52	51	48	51	51	54	56	54	54
Total Expenses	**109**	**104**	**100**	**95**	**96**	**97**	**99**	**100**	**97**	**100**

4.2 Expenses by segment

Expenses differ greatly between different segments of the superannuation industry. Table 5 and Table 6 show the breakup of operating and investment management expenses (respectively) by industry segment. Note that small funds (mainly SMSFs) are excluded from this analysis - by definition fees and expenses within small funds are equivalent. The remainder of this report deals with expenses in fees with 'large' funds only.

Table 5. Operating expenses (percentage of assets) over 10 years – by segment

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
	(bps)									
Corporate	37	32	32	26	26	29	31	32	30	29
Retail	61	62	57	57	53	50	48	49	48	50
Industry	57	52	47	44	43	50	51	48	48	48
Public Sector	24	24	24	17	21	24	28	25	27	27
Total Operating Expenses	**54**	**53**	**49**	**47**	**45**	**46**	**45**	**44**	**44**	**45**

Table 6. Investment management expenses (percentage of assets) over 10 years – by segment

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
	(bps)									
Corporate	56	56	56	53	53	54	51	52	51	54
Retail	57	50	50	46	50	50	58	61	58	60
Industry	51	51	51	53	57	55	56	58	56	57
Public Sector	50	54	50	40	39	36	39	38	37	35
Total Investment management Expenses	**55**	**52**	**51**	**48**	**51**	**51**	**54**	**56**	**54**	**54**

The costs vary greatly among the fund types. Reasons for these differences include:

- Whether the fund is 'for profit' or not.
- Differences in asset allocation.
- Percentage of assets invested passively.
- Differences in average member balances.
- The type of benefits provided (defined benefit, defined contribution, pension).
- The level of services provided.

4.3 Operating expense components

To better understand how the costs have changed during the past 10 years, we have also examined the distribution of major expense components. Table 7 summarises this information for operating expenses by all fund types, weighted by the fund assets (according to APRA expense categories).

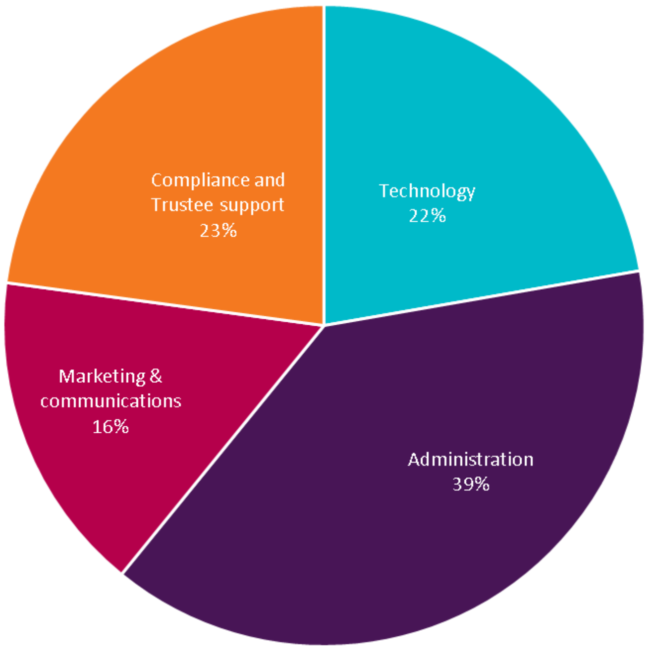
Table 7. Total operating expenses in the past 10 years by components

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
	(bps)									
Administration	36	34	30	28	26	28	30	30	31	31
Trustee support/general management	7	8	9	8	8	8	8	7	7	8
Fees paid to actuaries and audit firm	1	0.7	0.6	0.4	0.4	0.4	0.5	0.4	0.4	0.3
Other operating expenses	9	9	10	10	11	9	6	6	5	6
Total Operating Expenses	**54**	**53**	**49**	**47**	**45**	**46**	**45**	**44**	**44**	**45**

Administration expenses contain the largest 'variable cost' component (expenses that are scalable depending on the size of the operation). Trustee support/general management expenses and fees paid to actuaries and audit firm, fall mostly into the 'fixed overhead' category. These expenses generally decrease as the fund size increases.

More detailed expense categorisation would be desirable. Rice Warner's expense benchmarking report in 2012 analysed a peer group of funds and found that operating expenses could be broken up into different categories as shown in Graph 1.

Graph 1. Operating expense components – expense survey 2012



4.4 Investment expense components

We have also further broken down the components of investment expenses. Table 8 summarises this information by fund type, weighted by fund assets (according to APRA expense categories and indirect expenses).

Table 8. Total investment expenses in the past 10 years by components

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
	(bps)									
Direct management fees	27	25	24	24	26	25	30	32	28	29
Indirect expenses	23	22	21	21	21	21	21	20	21	20
Custody	1	1	3	2	2	2	2	1	2	2
Asset consulting	1.6	1.9	0.9	0.4	0.4	0.4	0.3	0.3	0.2	0.3
Other investment expenses	02	02	02	02	02	02	02	02	03	03
Total Investment management Expenses	**55**	**52**	**51**	**48**	**51**	**51**	**54**	**56**	**54**	**54**

'Indirect expenses' comprise mainly investment management fees which are not passed through fund financial statements as a direct fee paid to a manager, but which are indirectly incurred, generally via an adjustment to unit prices within a trust or bundled investment arrangement. Note that 'indirect expenses' can be passed to members either as part of investment management fees or through reduced investment earnings reported.

We have identified total management fees using each fund's Investment Cost Ratio (ICR) breakup applied to average assets per investment option (data from our survey), then subtracted direct management fees (from the fund's APRA return) to obtain a reasonable estimate of the indirect component.

For most surveyed funds, other investment expenses include costs relating to in-house investment teams and managing direct investments and expenses.

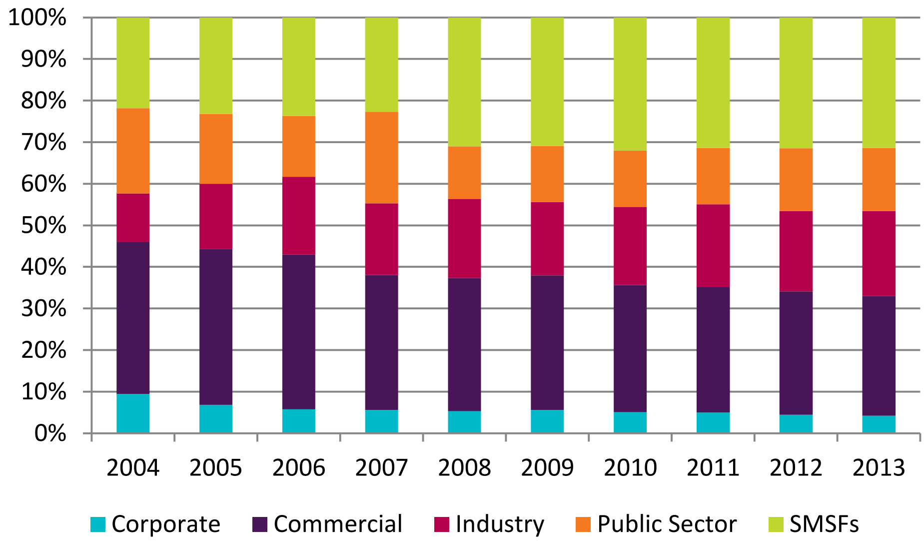
More detailed breakdowns of costs by component and fund types are given in Appendix A (Detailed tables and graphs).

5. Market forces

5.1 Market share

Market shares in the industry have changed dramatically over the past decade; this is demonstrated in Graph 2.

Graph 2. Market share 2004 - 2013



We estimate that if market shares had remained unchanged from 2004, as at 30 June 2013 the average fee rate for funds (excluding SMSFs) would be 1.19% (0.6 bps lower than currently).

This is an interesting result and captures the effect of the movement of assets between sectors i.e. the decline of retail, corporate and public sector funds relative to the rise of industry funds.

Table 9. Effect of changes in market share

Sector	Market share		Fee 2013 (bps)	Effect on total fees if market share unchanged from 2004 (bps)
	2004	2013		
Corporate	12%	6%	78	-2.5
Commercial	47%	42%	157	1.8
Industry	15%	30%	107	1.9
Public Sector	26%	22%	76	-1.8
Net effect	**100%**	**100%**	**120**	**-0.6**

The effect shown in this table is complicated as it ignores interactions that changes in market shares can have on expenses. For example, corporate fund fees have been able to remain low as smaller funds with higher costs have outsourced to MEFs (discussed in the next section).

5.2 Outsourcing of corporate funds to multi-employer funds (MEFs)

Over the last 10 to 15 years, there has been a gradual move towards the outsourcing of corporate superannuation arrangements. The number of standalone corporate funds (i.e. those with their own trustees) has reduced from fourteen hundred to just over one hundred funds over this period.

The major drivers for change have been:

- Onerous legislative and compliance requirements.
- A global move away from defined benefits to accumulation-style benefits, particularly in Australia.
- The introduction of compulsory superannuation, which has reduced the perceived attraction of company-sponsored retirement funding as a valued employee benefit.
- Volatile investment markets and a desire for employers to de-risk their retirement funds.
- The availability of quality outsourcing arrangements, capable of handling complex benefit designs.

The trend has continued in recent years, with the introduction of the Federal Government's 'Stronger Super' legislation, particularly the requirement for Superannuation Guarantee contributions to be made to an approved MySuper fund. The trend is evident in the large reduction in the number of corporate funds since 2004 as shown in Table 10.

Table 10. Reduction in the number of corporate funds

Year	Corporate
2013	108
2012	122
2011	143
2010	169
2009	191
2008	227
2007	291
2006	555
2005	962
2004	1,405

Rice Warner assisted many of the 'early adopters' to choose a suitable fund and ran our first outsourcing tender in 1996. Since then, Rice Warner has helped hundreds of Australian companies through the process, most of which chose to fully outsource.

Outsourcing of funds almost always results in a reduction in member fees. In our experience, corporate funds engaging in a tender process have achieved an average reduction in member fees of **43 bps p.a.**

Despite the high average decrease in fee per transfer the overall effect is small due to the small market share of this segment. We estimate that outsourcing of corporate funds has reduced overall market fees by **3 bps over 10 years.**

It is interesting to note that fees for remaining corporates have actually increased over 10 years despite this consolidation, which probably reflects increased costs of compliance.

5.3 Mergers

Rice Warner has assisted with and observed many mergers between funds over the past decade. We have conducted an analysis over a number of funds that have merged and found the following:

- When merging, the funds usually adopt a fee basis which is the lower of the two partners prior to the merger.
- Expenses reported to APRA in the year following are often larger than the sum of the expenses of the merger partners in the previous year, this may reflect:
  - short term merger costs
  - normal expense growth
  - increases in services.

Anecdotally, we understand that many funds view savings from mergers to represent an opportunity to provide members with enhanced services. The combined funds often redeploy staff and do not generate many internal economies. Fees do not immediately increase in the short term, but may reduce for members of the smaller merger partner.

Mergers do have a longer term benefit in reducing costs arising from increases in scale. Despite this, from our research and experience, they often do not provide any discernable short term reductions in fee rates. In reality, the larger fund tends to increase service levels to members which requires a growth in staff.

5.4 Movements of high balances to SMSFs

The SMSF sector has grown in market share significantly over the last decade. The movement of members to SMSFs results in lower fee revenue for the rest of the superannuation market. There is close to one million SMSF members in Australia compared to approximately 30 million member accounts overall. Despite this, SMSFs account for nearly a third of all superannuation assets.

This observation leads to the conclusion that SMSF members have significantly higher balances than the average superannuation member across the rest of the industry.

If SMSF assets had grown at the same rate as the market did from 2004 to 2013 (11.1% p.a.), APRA regulated and regulation exempt superannuation funds would currently have an additional fee revenue of $1.9 billion (120 bps average fee rate x $159b in additional assets) for the year ending 30 June 2013.

The additional assets would result in greater scale for the average superannuation fund. It is difficult to separate the effect this would have on fees from other market forces, particularly the share of pension assets as described in the next Section 5.5 (Pensions)

5.5 Pensions

Pension products have a number of features which affect their cost relative to accumulation accounts:

- Pensions are more costly to administer, and members in pension divisions are typically charged a higher fee (dollar fee) than those in the accumulation stage.
- Investments by pensioners are typically more conservative, resulting in lower fees.
- The average balances in pension accounts are higher than average accumulation balances resulting in lower fees.

Since 2004, the market share of pensions has grown from 21.7% to 30.4% of total assets, however, the market share of pension assets for funds excluding SMSFs and SAFs has only increased marginally from 19.5% to 22.0% from 2004 to 2013 due to:

- The majority of pension asset growth occurring in the SMSF segment (from 25.0% to 49.0% of all SMSF assets).
- Declining share of pension assets for public sector funds (from 25.6% to 22.1% of public sector fund assets).

This has occurred despite increases in the pension share of assets within Industry and Commercial funds over the last decade.

Differences in fees for pension segments and the impact of the change in the share of pension assets is illustrated in Table 11. These calculations demonstrate that the decline in the pension share of assets may have exerted an upward pressure of **1 bps** on fund fees over the last decade.

Table 11. Pension vs. accumulation fees

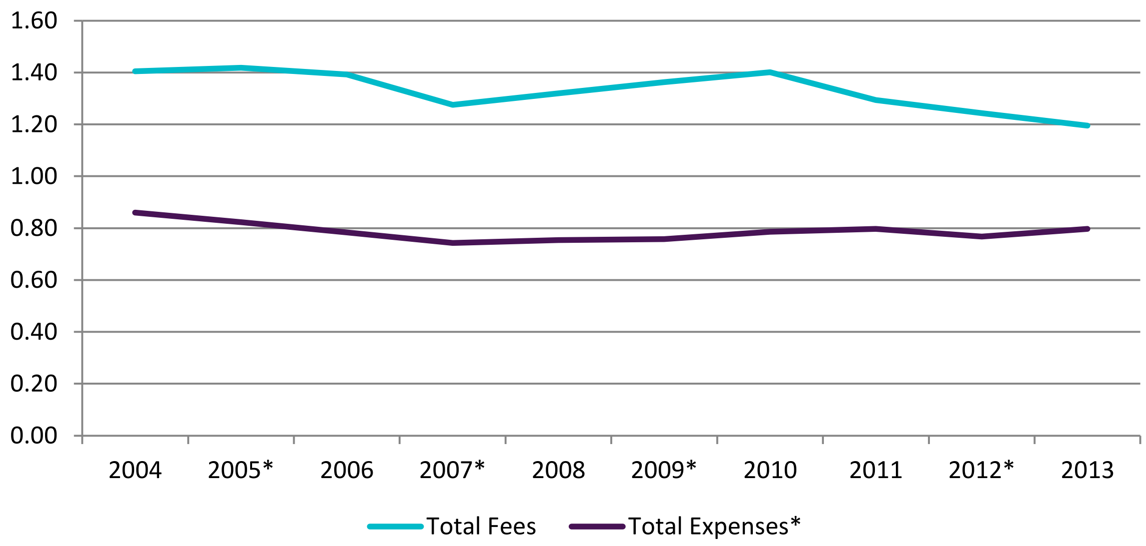
Segment	2013 Fees (bps)			Pension share of segment assets (%)		Difference in total fee using 2004 pension share (bps)
	Accumulation	Pension	Total	2004	2013	
Corporate Funds	78	62	78	6.80	5.40	-1
Industry Funds	110	93	107	1.40	8.20	3
Public Sector Funds	81	59	76	25.6	22.1	-1
Commercial	150	171	157	25.0	34.1	-2
Total	**119**	**136**	**120**			**-1**

5.6 Margins

5.6.1 Fees vs. expenses

Graph 3 compares fees and expenses for all funds (excluding SMSFs) over the past 10 years. Expenses have remained relatively static, falling 9 bps from 109 bps to 100 bps over 10 years. Fees on the other hand have shed 20 bps falling from 140 bps to 120 bps for 'large' funds over 10 years.

Graph 3. Fees vs. expenses 10 years



*Fees have been estimated in some years by interpolation; note that when measuring margins we have excluded indirect investment costs from expenses as these could be considered an additional fee.

Differences between fund expenses and member fees may reflect:

- use of fund reserves to manage expenses from year to year
- employer fee subsidies (in the case of corporate or public sector funds), or
- a commercial fund's profit margin.

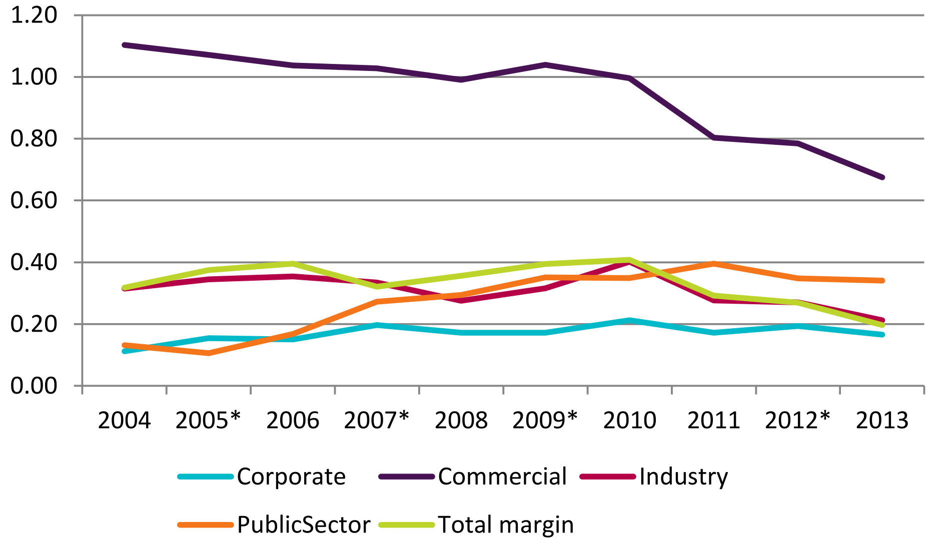
5.6.2 Decline in margins

As shown in Graph 3 the margin in fees over expenses has declined by 11bps over the last 10 years. The decline in the margin could be attributed to:

- competitive pressure causing funds to reduce their margins
- changes in market share between commercial and not for profit sectors.

Graph 4 shows the measured margin by segment over the last 10 years. The graph shows that margins have decreased significantly for retail funds and have not changed substantially in other sectors.

Graph 4. Margin by segment



Reasons for the decline of retail margins include increased competition for members with the introduction of choice of fund in 2005.

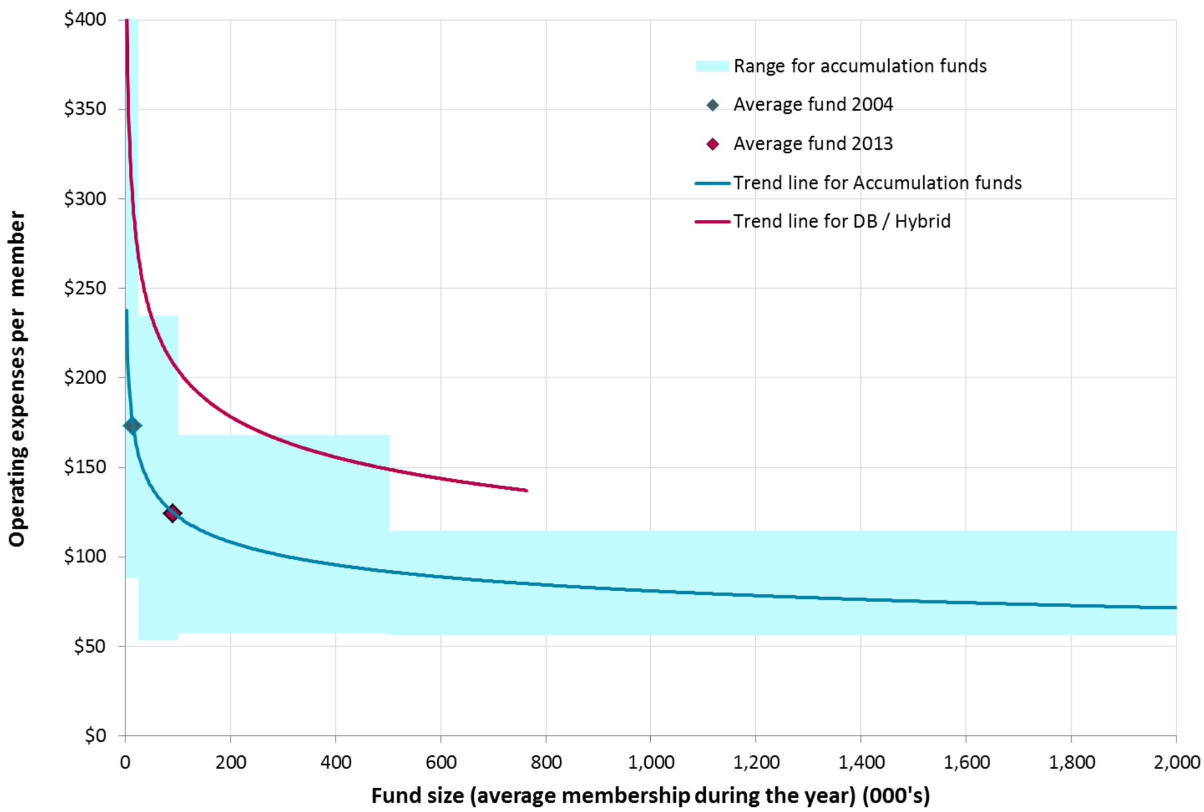
6. Operating expenses

During the past 10 years, operating costs have been driven by a number of factors. Key drivers of operating costs are discussed in this section.

6.1 Operational scale

Rice Warner regularly conducts research into superannuation fund expenses. Graph 5 shows the impact that scale has on fund operational expenses (per member) from our 2012 expense benchmarking survey.

Graph 5. Superannuation fund expenses



We have plotted on this graph the average fund size[1] (excluding SMSFs and SAFs) as at 30 June 2013 and 30 June 2004 to demonstrate the cost savings per member that should have been achieved since 2004 from scale benefits alone (based on 2012 data).

The expected saving shown above equates to **14 bps** over 10 years in scale benefits on operational expenses.

[1] Average fund size based on the *APRA Annual Superannuation Bulletin June 2013.*

6.2 Increased average account balances

According to APRA data, average account balances (for funds excluding SMSFs) have increased from $18,000 in 2004 to $35,800 in 2013. If per account operational costs had stayed constant over this period (apart from indexation in line with CPI of 3%) it would be expected that operating expenses would have reduced by **19 bps** when expressed as a percentage of assets.

We have made this calculation in respect of operating expenses only as these costs consist mostly of variable administration fees on a 'per account' basis. The bulk of investment expenses are variable expenses expressed as a percentage of funds under management.

6.3 Regulation

6.3.1 MySuper

MySuper is the result of the Super System Review's proposal for a simple, low-cost 'default' option to be used for the 80% of employees who are deemed to be 'disengaged' with their superannuation fund. Funds have been able to offer a MySuper product since 30 June 2013. Consequently the impact of MySuper on the fees in the market had not been captured for fees up to 30 June 2013.

MySuper will have a profound impact on fees within the superannuation industry and will commoditise superannuation products. This will arise from a number of mandated features of a MySuper product, including:

- A single default investment strategy 'MySuper' (members who wish to elect an alternative strategy will need to hold a Choice product).
- Standardised fees for all members within a MySuper product (which employers may subsidise). Employers may negotiate a discounted fee for their employees who are members if this can be justified.
- Basic default Death and TPD insurance on an 'opt-out' basis.
- No commissions to advisers.
- Large employers (500+ employees) may negotiate a tailored MySuper product.
- MySuper does not apply to defined benefit divisions or retirement products.

Despite MySuper being tailored to the 'disengaged member', funds are able to build intra-fund advice into their fees and MySuper members are also able to apply for additional insurance without being Choice members.

Employers have been required to make default contributions on behalf of their employees to a MySuper product since 1 January 2014.

6.3.2 SuperStream

SuperStream is a key recommendation of the Cooper Review that has been supported by the Government. SuperStream will enforce electronic commerce within superannuation as well as account consolidation over three years.

SuperStream will facilitate account consolidation through the use of a member's Tax File Number (TFN) as the primary locator of member accounts. Intrafund consolidation became effective from 1 July 2013. The government also announced increases to the threshold below which lost accounts are transferred to the ATO. As a consequence of this measure, it is unlikely that inter-fund consolidation will be implemented

With the existence of over 20 million unnecessary accounts within the superannuation system, SuperStream is a step in the right direction.

6.3.3 Account consolidation

The second component of SuperStream is the application of data standards and e-commerce for funds and employers. These data standards will remove several inefficiencies that have been allowed to develop within the industry, affecting in particular the costs of collecting and allocating member contributions.

The improved efficiency of collecting and allocating contributions will lead to lower costs. Again, the biggest saving will come from the industry fund sector. It is not clear whether the savings will outweigh the impact of increased per capita costs from account consolidation.

Despite the efficiency gains that will arise from SuperStream, in the short term implementation costs have put an upward pressure on fees.

6.3.4 Reform implementation costs

The implementation of recent reforms (including MySuper and SuperStream) has pushed up short term costs for superannuation funds. In our consulting experience, we have observed funds budgeting between **5 to 10** bps of FUM to fund projects related to the Stronger Super and Future of Financial Advice (FoFA) reforms. These costs are short term and have been spread over the last two years. They should not have a lasting impact on fees.

Overall, for the 2013 financial year we estimate that implementation costs have put upward pressure on fees of **4 bps.**

6.3.5 Impact on fees

The introduction of MySuper led to significant margin compression on the Commercial master trusts. Most have settled on asset-based fees of just under 1% a year which is more expensive than the large industry funds, but much lower than their previous products (which also included the cost of advice).

Many funds have introduced lifecycle investments which also help to curb fees (MySuper legislation allows four different pricing points for these products). This occurs as those with the highest balances are older and have higher proportions of relatively cheaper defensive assets.

Apart from different investment structures, the other areas of product differentiation are:

- sophisticated advice models
- life insurance

- member services – which depend in part on the quality of administration platforms
- introduction of member-direct investments as a defence against members shifting to the SMSF segment.

We have also seen the beginnings of member analytics as funds start to shift to a member-centric world.

At the time of writing, APRA lists 117 authorised MySuper products of which 79 are Public Offer funds and 38 are Non Public Offer. The number of authorised products is much lower than the 200 that APRA expected when the legislation was initially drafted.

We have examined the change in fees for 98 of these MySuper products as at the time of writing this report against the fees we recorded for the default options in the same funds at 30 June 2011. We were unable to capture the full market due to an absence of data in 2011 for some small corporate funds and corporate divisions of retail funds as well as the creation of some new products not existing in 2011.

The results of our analysis are given in Table 12. We have weighted average results by assets and members as at 30 June 2013. We have combined fees for Retail products and large Corporate Super Master Trusts under the heading 'Retail'.

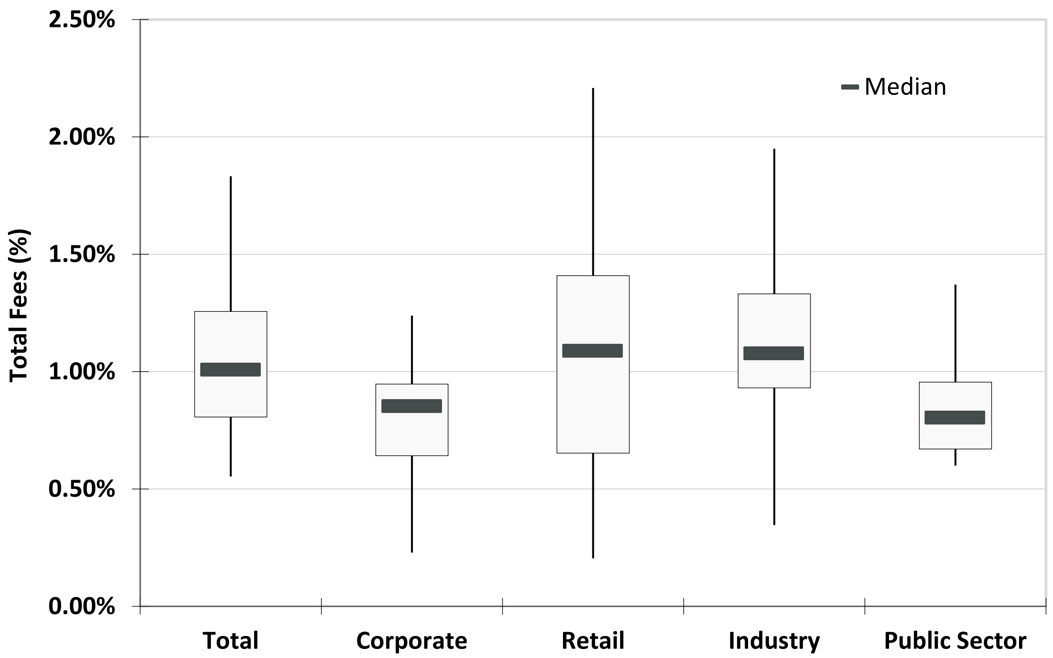
Table 12. MySuper product fees – 2013 (Average fee by account balance (percentage % of assets))

Segment	Average $ per member fee	Average % of assets fee	$5,000	$20,000	$50,000
2011					
Corporate	47	0.62%	77	170	355
Retail	64	1.61%	144	385	867
Industry	68	0.76%	106	220	449
Public Sector	28	0.58%	57	144	317
Total	**63**	**0.92%**	**109**	**248**	**525**
2013					
Corporate	81	0.69%	115	219	426
Retail	72	0.82%	112	235	481
Industry	74	0.72%	110	217	433
Public Sector	29	0.64%	61	156	347
Total	**69**	**0.73%**	**106**	**215**	**433**

The results show that average fees have come down overall due to a reduction in asset based fees, however, dollar based fees have increased. The largest reduction has occurred within retail fund offerings with a reduction in percentage based fees from 1.61% to 0.82%. Average fees for corporate and public sector funds have actually increased.

The distribution of MySuper fees captured varies by segment as shown in Graph 6.

Graph 6. Distribution of total MySuper fees by segment



From the results of our analysis we expect that the introduction of MySuper will cause fees to converge to 1% of assets in the next few years.

6.4 Marketing costs

Marketing costs have become an increasingly large component of superannuation fund budgets over the past decade. Competition for members increased with the introduction of choice of superannuation fund legislation which came into effect from July 2005, and impacted the majority of workers in the private sector (choice for federal public servants was awarded in July 2006).

The more recent debate regarding opening the modern awards via the Fair Work Commission indicates that competition for members is only likely to increase in the near future. This increased competition for members has and will continue to increase the amount spent by funds on marketing.

A decade ago, the total spent on marketing for the average superannuation fund would have been a negligible percentage of assets. Graph 1 indicates that Marketing and Communications account for 16% of fund operating expenses in 2012. Of this, our surveys indicate that 65% relates to marketing, business development, advertising and sponsorship. Applying these percentages to current operational expenses (45 bps) indicates that the increased spending on marketing could have resulted in upward pressure on fees of **5 bps** over 10 years.

6.5 Financial advice

With the implementation of Future of Financial Advice (FoFA) in July 2013, we have observed a trend towards a reduction in advice costs. Not for profit funds are also increasingly building simple 'intra-fund' advice into their operating models which puts an upward pressure on operating expenses.

Intra-fund advice (or single issue advice) is often provided by superannuation funds to members. The advice is commonly provided over the phone by the fund's call centre or an outsourced financial planning organisation. Intra-fund advice is defined as 'the types of advice that a superannuation trustee can provide to members where the cost of the advice is borne by all members of the fund'.

There are a variety of different approaches that funds take to charging members for advice. The typical cost of a piece of advice ranges from $150 to $300, however, many members are unwilling to pay directly for this advice. This leads many funds to pay for intra-fund advice via the administration fee which is charged to all members. Under this model, all members pay a proportion of the cost of advice regardless of whether they actively seek advice or not.

Some funds adopt a mixed approach, where some advice may be provided to the member at no direct cost and other pieces of advice may carry a specific charge (for example, the first piece of advice may be provided to a member for free, but subsequent pieces of intra-fund advice may incur a direct charge).

Graph 7 gives a breakdown of the percentage of funds adopting these different approaches based on a survey of funds as at 30 June 2013.

Graph 7. How members pay for intra-fund advice

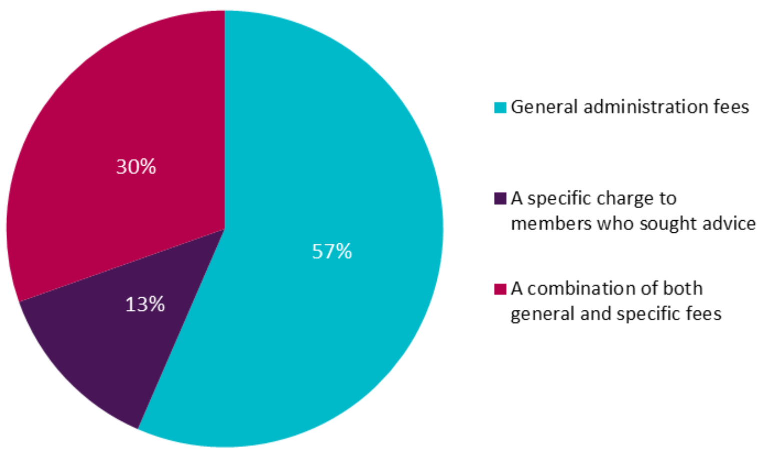


Table 13 provides the Rice Warner estimate of the cost of intra-fund advice by industry segment as a percentage of assets.

Table 13. Cost of advice by industry segment

Sector	Segment	Intra-fund advice	Total Advice
		(bps)	
Wholesale	Corporate	1.5	2
	Corporate Super Master Trust	4	19
	Industry	3	4
	Public Sector	3	4
Retail	Corporate Super Master Trust	4	24
	Corporate Super Master Trust	4	16
	Personal Superannuation	4	36
	Retirement	4	54
	Retirement Savings Accounts	0	0
	Eligible Rollover Funds	0	0
Small Funds	Small Funds	0	15
Total		**2**	**17**

From our research we know that intra-fund advice costs close to 3.3 bps p.a. across the market (excluding SMSFs). Given that 57% to 87% of this cost is paid for out of administration fees (rather than a separate fee charged to the member) we estimate that building intra-fund advice into standard operating models has put upward pressure on fees of **2 bps.**

6.6 Operational risk reserves

Many funds have introduced an additional levy on members to build up operational risk reserves; these reserves are typically targeted at 0.25% of funds under management and are being built up over a period of three years. Some retail providers are using trustee capital in the place of a specific levy on members and other funds are segregating assets in an existing 'administration reserve' in order to meet this capital requirement. The introduction of the Operational Risk Financial Requirement (ORFR) from 1 July 2013 is expected to cause an increase in fees (where fees are defined to include this levy) of approximately 5bps to 10bps p.a. across the market over the next three years.

6.7 Larger fund secretariats

A decade ago, many funds would have employed a single fund secretary to manage service providers and other fund activities. Today, fund trustees employ a much larger number of people and dedicate large teams to member services, strategy, advice and operations. To a degree, this activity has simply been cost shifting as funds continue to insource many activities as they grow larger. However, we expect that many of these additional expenses are additional to what was incurred in 2004.

We have not provided an estimate on the impact of this increased cost on fees (as a percentage of assets) as we expect that it is marginal.

7. Investment expenses

7.1 Larger investment mandates

As the size of the average superannuation fund grows they have increased power to bargain with investment managers for a lower investment management fee. This can be illustrated in Graph 8.

Graph 8. Investment expenses by fund size (net assets)

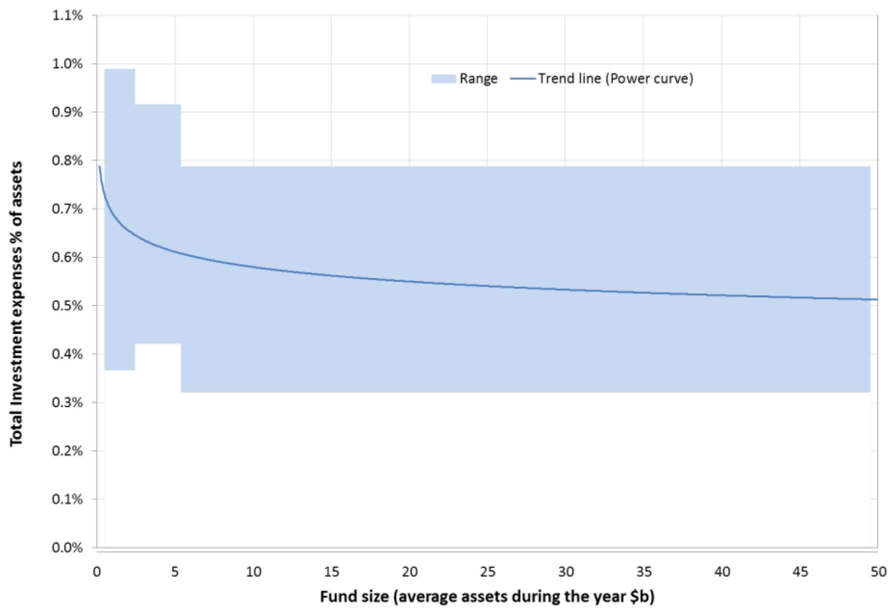


Table 14 summarises our research showing the average investment management fee (in basis points) by asset class by the size of the investment mandate.

Table 14. Median investment management fees (bps) by size of the mandate

Asset class	Up to $50m	$50m to $100m	$100m to $250m	$250m to $500m	Over $500m
Cash	20	13	9	7	6
Fixed interest	47	37	32	27	22
Australian shares	80	69	58	43	28
International shares	82	73	63	48	n/a*
Listed Property	62	51	40	n/a*	n/a*

* n/a – cannot be estimated with the available data

As mandates grow ever larger savings in fees reduce until they hit a floor. Very few funds will provide managers with a mandate that is larger than $500 million. Large funds use multiple managers for each asset class (to reduce risk), reducing the size of the investment mandates (and reducing the scale benefits of using fewer managers).

This is illustrated in Graph 8, which shows a significant difference between investment management expenses in small and medium funds. However, the scale of larger funds does not appear to offer them any significant further savings.

Due to market consolidation, the average fund size has significantly increased during the past 10 years. We have estimated that across the whole market, the savings in investment management fees due to the increase in the size of the funds should be about **9 bps** from 2004 to 2013.

This is calculated according to the data which is illustrated Graph 8 above and the historical average size of the funds in 2004 and 2013.

7.2 Increased costs after GFC

We have observed (Table 4) consistent reduction in investment management expenses with increased fund sizes, prior to the Global Financial Crisis (GFC).

However, after GFC, especially in 2010 and 2011, the direct investment management expenses have increased significantly, as managers start to charge higher fees to build up higher reserves and profit margins, in the new investment environment. This is especially evident for the Retail funds, illustrated in Table 24 in Appendix A (Detailed tables and graphs), as the investment management costs of Retail funds are usually charged by its parent group.

We have estimated that the effect of cost increases following the GFC has put upward pressure of **8 bps** on fees across the market.

7.3 Asset allocation

We have estimated the total changes to asset allocation in the past years have increased the average investment cost across the market by about **3 bps**.

7.3.1 Growth of alternative investments

Following GFC, many funds in Australia have switched their assets to unlisted assets such as direct properties and infrastructures. These assets are considered to be able to provide stable income streams which are generally inflation related, the return volatility is low and the expected return is higher than traditional defensive assets due to their illiquidity premium.

Table 15 shows the changes in asset allocation across all types of funds from 2004 to 2013.

Table 15. Asset allocation across the market in 2004, 2007 (prior to GFC) and 2013

	2004	2007	2013
	(%)		
Australian Shares	32.7	33.6	27.4
International Shares	20.6	25.7	22.4
Listed Property	2.4	4.3	2.7
Direct Property	3.5	4.6	6.2
Australian Fixed Interest	15.2	10.1	10.5
International Fixed Interest	5.6	4.7	5.8
Cash	7.0	7.4	10.8

	2004	2007	2013
Infrastructure	1.2	3.5	6.4
Other Alternatives	11.9*	6.1	7.9

* In 2004, APRA has classified a large proportion of Corporate and Retail fund assets as 'Others', which include assets in collective investments.

These illiquid assets generally incur higher costs to manage. As illustrated by Table 16, the cost of a mandate to manage unlisted assets is much higher compared to the cost of managing listed assets[2].

Table 16. Average investment management fees (bps)

	Fees (bps)
Cash	18
Fixed Interest	48
Australian Shares	84
International Shares	88
Listed Property	65
Direct Property and Infrastructure	122

7.3.2 Potential shifts to passive investments

Passive management means the investment manager attempts to achieve the same performance as the benchmark or market, as closely as possible. While active management involves the investment manager attempting to outperform the market return by holding higher allocations to individual investments that they expect to perform well.

Table 17 summarises the average fees charged by active and passive funds, estimated according to available market data[3]. We see that there are significant differences in investment costs of active and passively managed investments.

Table 17. Average investment management fees (bps) of Active and Passive funds

	Active	Passive
Cash	15	0
Fixed Interest	58	27
Australian Shares	93	30
International Shares	99	42
Listed Property	79	46

[2] Many funds are in the process of internalising the management of unlisted assets. We expect the cost of these assets to decrease significantly if they can be managed by the fund's internal team instead of mandated to external managers. However, most funds are still building this capability hence the cost reduction will come in the future.
[3] These are estimated using a sample of 293 funds. Note this is not weighted by the FUM of the funds therefore the results are biased towards smaller size funds.

Since the GFC, we have observed the growth in passive investments over actively managed funds across the globe, as a significant development in the worldwide funds industry. However, in Australia, we have only seen a pick-up in the demand for passive funds more recently, due to the implementation of the MySuper product. Several funds have shifted to passive investments to curb the fees of these products.

With the introduction of MySuper, our research indicates that:

- Many large industry funds continue to invest actively and have left their allocations unchanged.
- Some smaller industry funds have increased the proportion of passively managed assets in their portfolios to reduce costs.
- Corporate and public sector funds have largely left their allocations unchanged.
- Several retail funds have introduced passive portfolios but have not passed on the cost savings to their members.

7.4 Member direct investments

Apart from different investment structures due to MySuper, one of the other areas of product differentiation is the introduction of member-direct investments (MDI) as a defence against members shifting to the SMSF segment.

We have run a number of tenders for our superannuation fund clients on the implementation of MDI, and we are able to estimate the following costs.

Table 18. Cost of implementing MDI

Components	Cost
Upfront Implementation	$180k to $350k one off
Ongoing Fee	$40k to $60k per year
Member Fee	$180 to $200 per member per year

According to the average size of the funds that have implemented MDI, we estimate this has increased the average investment cost across the market by about **2 bps** per year[4].

[4] Assuming the upfront implementation costs are distributed over a five year period.

7.5 Higher performance fee

Over the last decade, there has been growth in performance fees for fund managers. Generally, these have been additive to existing investment management fees. Several funds have begun to negotiate better terms following the GFC when some fund managers had taken performance fees for a few years and these were not clawed back when returns fell.

The equity market has performed especially well in 2013. Using a sample of 324 investment options, we have estimated that the effect of higher performance fees had been about **2 bps** in 2013.

8. Additional drivers of fee levels

There are a number of additional factors that have led to the persistence of high fees / costs to members in the industry over the past ten years that have not been quantified separately in this report.

These factors include:

Inactive Accounts

The persistence of inactive accounts adds to costs, though the number of accounts has plateaued and is falling slowly. If members held a single superannuation account (as they would if it were a personal banking account), it would simplify their affairs and make administration easier for funds.

Rice Warner estimates that there are 2.1 accounts on average existing in the system per member. Further, couples need to hold separate superannuation accounts as it is not possible to hold a joint account. These superfluous accounts add 2 to 3 bps a year to fees.

Life insurance

Life insurance has become a complex part of every superannuation fund.

The cost of assessing insurance claims adds significantly to the operational costs of a fund. Further, as most funds offer voluntary additional life insurance, this has to be assessed and managed. A significant part of the insurance processes rely on manual processing of paper-based forms.

More recently, there has been significant growth in disability claims. Some claims have been lodged for events which occurred many years ago. There has also been a recent trend of insurance claims being introduced by lawyers who then charge members an upfront fee and a large percentage of the benefit. All this activity adds to the costs of funds.

Electronic commerce

The system will improve in time, particularly when the full SuperStream structure is in place. However, the system is still paper-based, for example:

- New members send in paper-based forms to join a fund. If they subsequently rollover existing benefits, they fill in a new form.
- Many contributions are being sent by employers backed by a cheque; many of these are sent quarterly in arrear which adds to the problems of reconciliation – especially when some members will have left the fund before their contributions are received.
- When accounts roll over between funds the fund requires a cheque and paper forms.
- Annual statements are being posted to members.
- Insurance notifications are also usually sent by mail.

Choice of investment strategy

Funds have multiple investment strategies, all of which require separate allocations of assets and calculations of unit prices (or crediting rates). This complexity creates additional work which is shared by the fund secretariat, administrator and custodian.

9. Results

Over the period from 2004 to 2013 we have observed fees falling by 20 bps for superannuation funds (other than SMSFs and SAFs).

Our analysis has found that a number of factors have put upward pressure on fees totalling **27 bps** including:

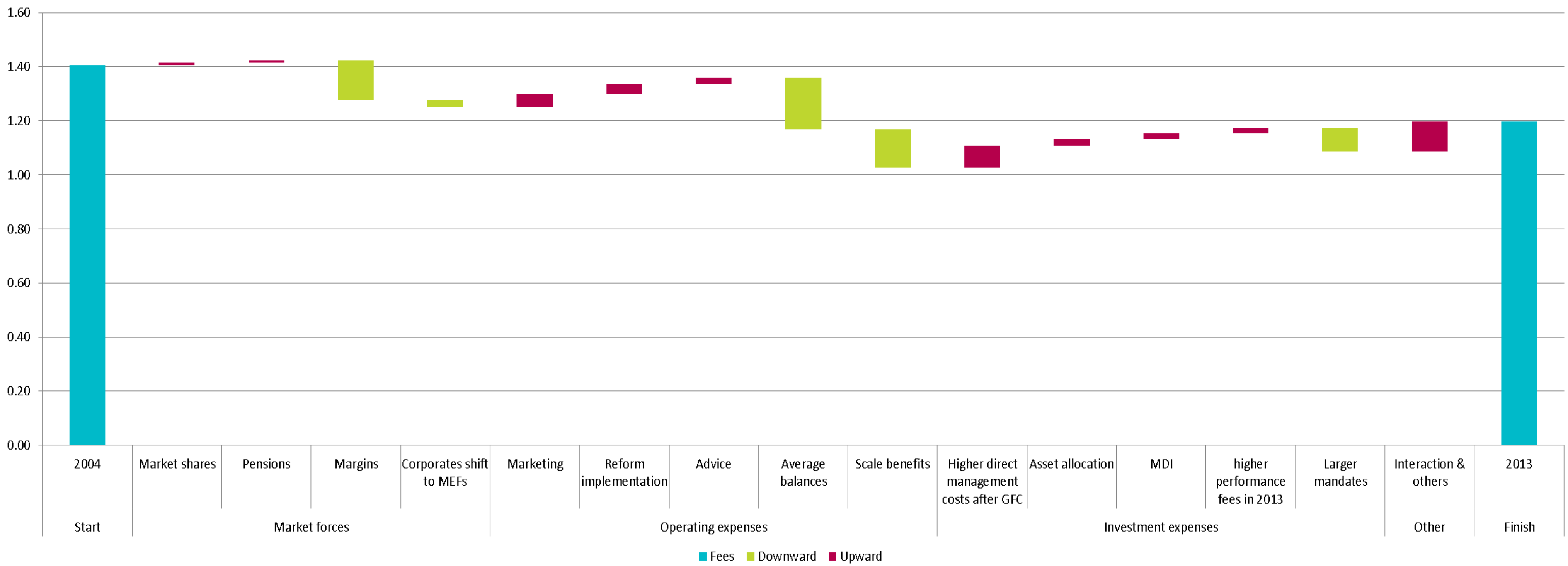
- changes in market shares between sectors
- changes in the market shares of pension assets
- increased fund spend on marketing
- implementation of recent superannuation reforms
- increase in spending on simple advice
- higher direct management costs following the GFC
- changes in asset allocation
- the introduction of member directed investments
- higher performance fees in 2013.

Offsetting this is a number of measures which have served to put downward pressure on fees totalling **59 bps** over the last decade:

- increased competitive pressures reducing margins
- corporate funds outsourcing to MEFs
- increased fund scale reducing operational costs
- higher average balances
- larger investment mandates

A summary of the relative impacts of each of these effects is summarised in Graph 9.

Graph 9. Summary of drivers of changes in fees 2004 to 2013



Appendix A Detailed tables and graphs

Table 19. Operating expenses in the past 10 years by components - Industry funds

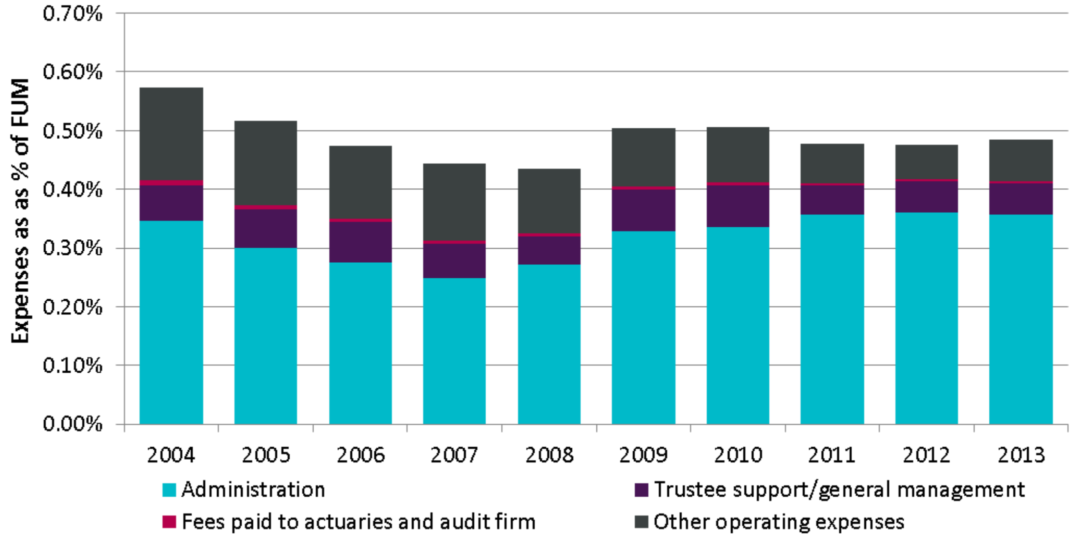


Table 20. Operating expenses in the past 10 years by components - Retail funds

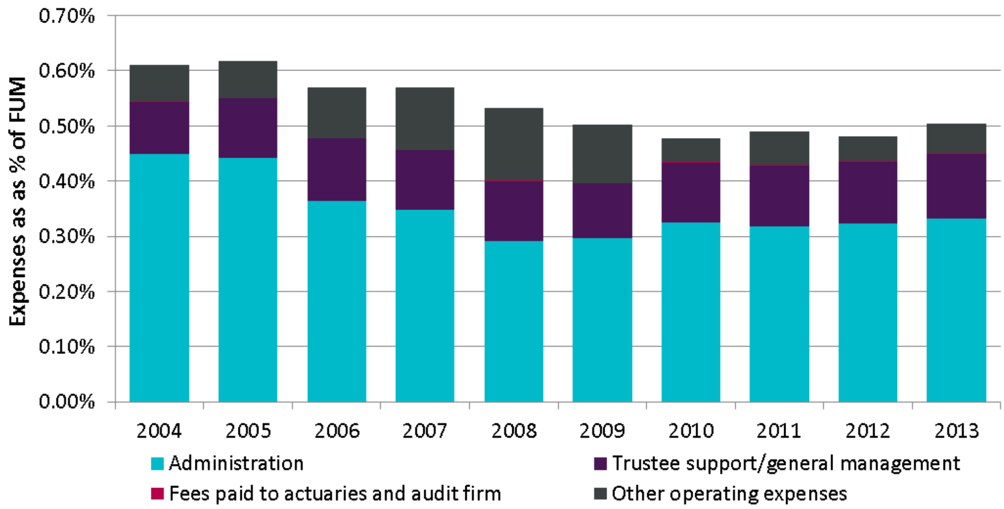


Table 21. **Operating expenses in the past 10 years by components - Public Sector funds**

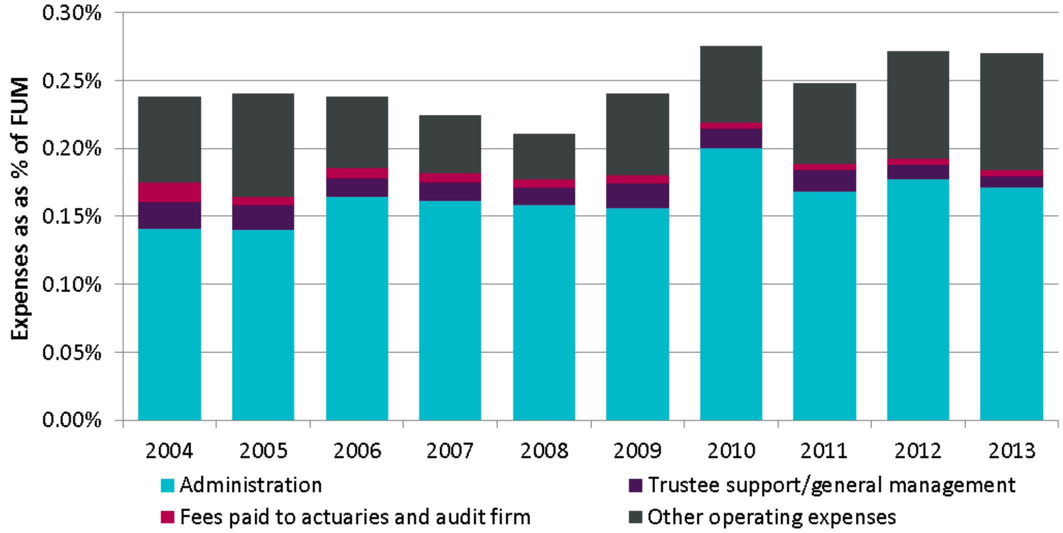


Table 22. **Operating expenses in the past 10 years by components -_ Corporate funds**

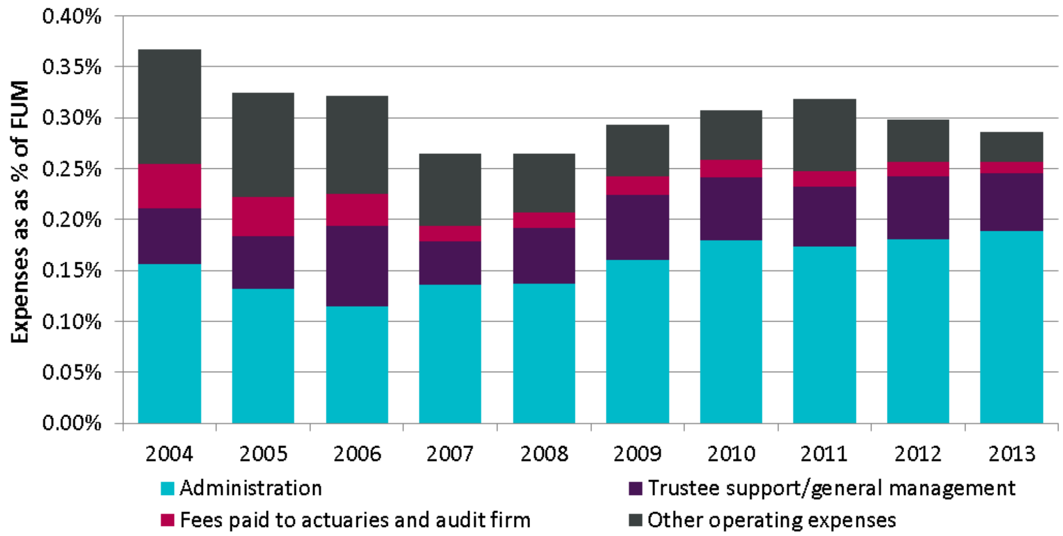


Table 23. Investment expenses in the past 10 years by components - Industry funds

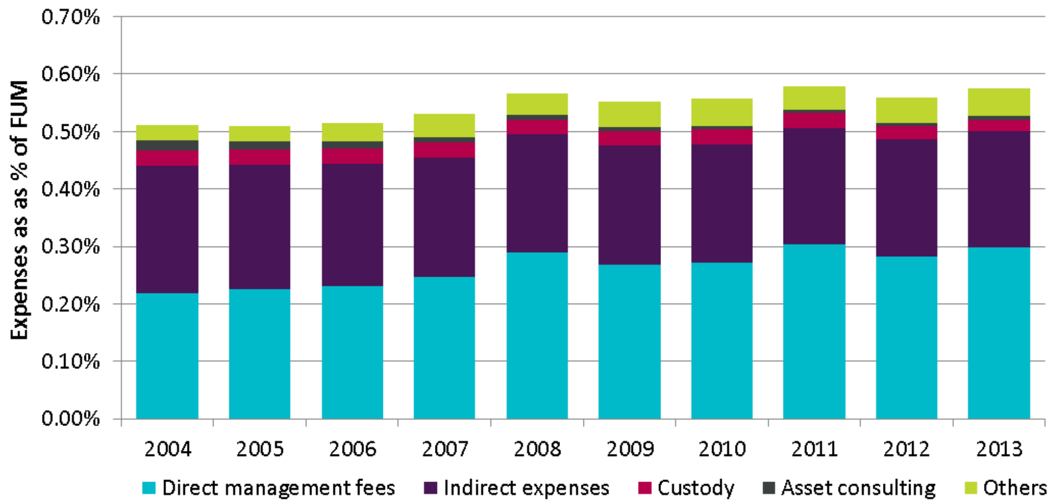


Table 24. Investment expenses in the past 10 years by components - Retail funds

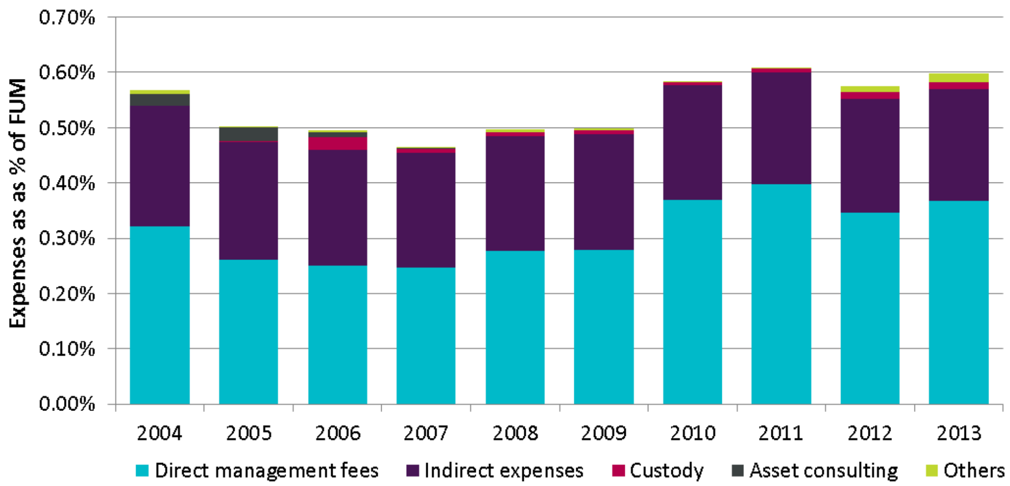


Table 25. Investment expenses in the past 10 years by components - Public Sector funds

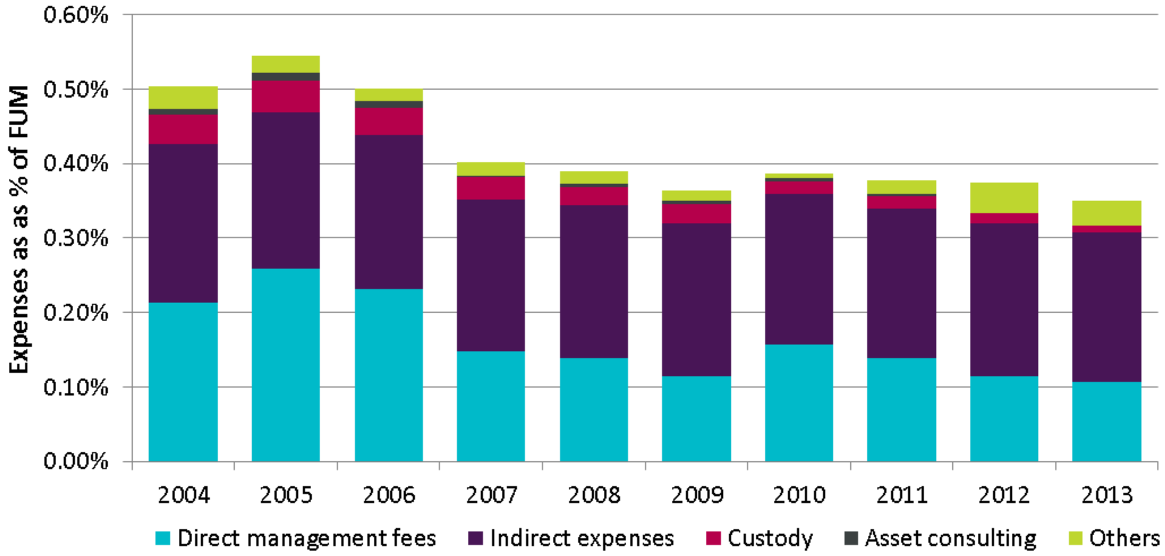


Table 26. Investment expenses in the past 10 years by components - Corporate funds