FINANCIAL SYSTEM INQUIRY

COSTS IN SUPERANNUATION

14 AUGUST 2014

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Mr David Murray
Chair, Financial System Inquiry
Electronic Submission

Dear Mr Murray

We are making this submission to address what we believe are important misconceptions that have arisen from the Interim Report issued by the Financial System Inquiry in respect of the costs of Australia's superannuation system. In particular we are concerned to redress the misconception that the cost structure of the system is 'inefficient' as a result of fees that are too high. This view has been popularised by the Grattan Report: Super sting: how to stop Australians paying too much for superannuation.

There are a number of reasons why the conclusion apparently reached by the Grattan report (and apparently endorsed by the Inquiry in its Interim Report) is in our view fundamentally unsound.

First, and most obviously, any comparisons have to be between alternatives that are similar. This point is recognised in the RBA submission to the Financial System Inquiry. Comparing the costs of Australia's system to international comparisons must recognise:

1 The objective of universal coverage necessarily results in many more small accounts than would exist in a less comprehensive system. Although the OECD reports that there are other systems in which coverage is very high (such as Chile, Denmark, Estonia, Finland, Iceland, Israel, the Netherlands and Switzerland) other countries (and most notably Canada, the US and UK) have much lower levels of coverage.[1]

2 The Australian system provides participants more choice than is present in most other jurisdictions. This choice is partly government mandated (Fund Choice) and partly market driven (Investment Choice). Care must be taken in interpreting the analyses pointing to the infrequency of members making switches between funds or fund options. The availability of choice is valuable, even if people do not use it in any given year to change their arrangements. Of course providing an operational infrastructure that facilitates choice increases costs. Whether this cost is 'worth it' depends on the value accorded to individual liberty, flexibility and agency. The fact that participation in the superannuation system is compulsory for employed Australians, and that amounts within the system are preserved until retirement age makes the ability of individuals to fine-tune their arrangements much more important than it would be in systems without such paternalism. Significantly, this capacity, but not obligation, to make choices was a fundamental element of the choice architecture model underpinning the Stronger Super initiatives introduced over recent years.[2]

1 OECD, Pensions at a Glance 2013, 189.

2 See Super System Review, Review into the Governance, Efficiency, Operation and Structure of the Superannuation System: Clearer Super Choices: Matching Governance Solutions, Preliminary Report of the Super System Review, December 2009 (available at <www.supersystemreview.gov.au>)

3 The fragmentation of the system that resulted from the decision in 1993 to employ private market participants to administer the monies mandated by the Superannuation Guarantee. A fragmented system (ie lots of funds) prima facie has less opportunity to harness economies of scale but is also potentially more resilient to local failures. In that light it is pertinent to note that no Australian fund currently comprises more that 7% of the system (by assets) and that measures of the overall concentration of the industry is substantially less than would typically attract adverse attention from competition regulators.[3]

4 There are material differences in the tightness of regulatory settings in different jurisdictions. This is a function of regulatory risk appetite which in turn is a function of political risk appetite. The delegation of responsibility for administration of the system to private entities means that criticism of the Australian system has fewer political ramifications than it would in a more centrally controlled, public system. Moreover, the focus on disclosure to consumers as a regulatory strategy not only implicitly transfers responsibility onto those consumers but also transforms the characterisation of those costs from regulatory costs into administrative costs.

5 Many of the systems to which the Australian system is compared are comprised predominantly of defined benefit schemes. The true costs of these types of schemes are systematically underestimated. This is not only because in many cases the employer pays for aspects of the administration of the scheme (although this is often true) but because the measures never take into account the implicit value of the guarantee.

It seems uncontroversial to note that the factors above lead Australia in fact to be more costly than systems in other countries. Notably, the first four are the result of policy decisions taken by government. They are outside the control of market participants. The Superannuation Guarantee, Fund Choice and the reliance on disclosure are valuable aspects of the Australian system, but they are inherent in the design of the system and are not a consequence of inefficient implementation. The fifth factor, the prevalence of DC schemes over DB schemes, makes the Australian system appear to be more costly, but only because the costs in other jurisdictions are understated.

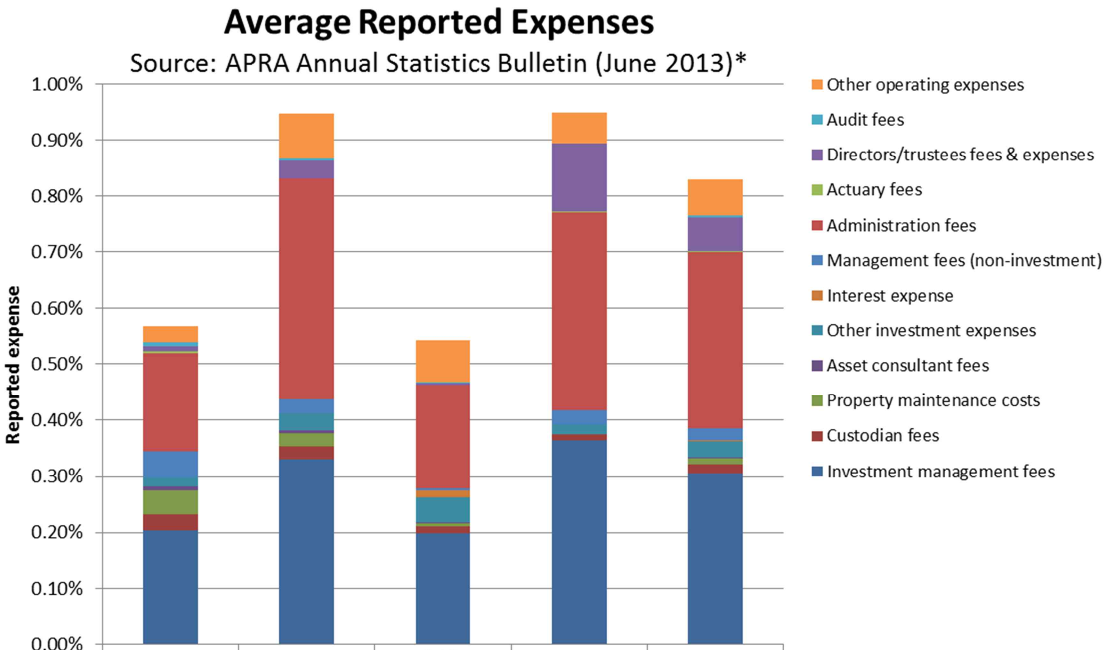
Second, there is no consistency in the way costs are reported and measured. This is true even within the Australian system. The operational structure of the system, including the extent to which it employs different types of legal structures, powerfully influences the extent to which payments made to non-members are even identifiable as costs, never mind whether they are reported as such.

Finally, the emphasis on cost comparisons with overseas jurisdictions is, with respect, itself misplaced. Opportunities for efficiency gains (which are expressly the focus of the FSI), ought to focus on the presence of economic rent, not on costs. Rent is the concept used by economists to describe the quantum of profit above that required to compensate for the risk undertaken. The appropriate question, then, is whether there are participants in the system earning economic rent?

This is not an easy question to answer. The first step is to disaggregate the costs incurred by superannuation funds so that direction of any leakages from fund performance can be identified.

[3] For instance the calculated HHI of funds in the industry is approximately 300; CLMR Working Paper 14-4, Bank Custodians and Systemic Risk in the Australian Superannuation System, available at http://www.clmr.unsw.edu.au/resource/risk/clmr-working-paper-14-4-bank-custodians-and-systemic-risk-australian-superannuation-system

The graph below is based on data collected and reported by APRA.[4]



	Corporate	Industry	Public sector	Retail	Total
Other operating expenses	0.03%	0.08%	0.08%	0.06%	0.07%
Audit fees	0.01%	0.00%	0.00%	0.00%	0.00%
Directors/trustees fees & expenses	0.01%	0.03%	0.00%	0.12%	0.06%
Actuary fees	0.00%	0.00%	0.00%	0.00%	0.00%
Administration fees	0.18%	0.39%	0.18%	0.35%	0.31%
Management fees (non-investment)	0.05%	0.03%	0.00%	0.03%	0.02%
Interest expense	0.00%	0.00%	0.01%	0.00%	0.00%
Other investment expenses	0.02%	0.03%	0.04%	0.02%	0.03%
Asset consultant fees	0.01%	0.01%	0.00%	0.00%	0.00%
Property maintenance costs	0.04%	0.02%	0.01%	0.00%	0.01%
Custodian fees	0.03%	0.02%	0.01%	0.01%	0.02%
Investment management fees	0.20%	0.33%	0.20%	0.36%	0.31%

The Graph shows that the majority of the costs occur in investment management (~0.30% per annum) and administration (~0.30% per annum). These contribute almost three quarters of the total average cost of 0.83% per annum reported by APRA.

Anecdotal evidence strongly suggests that there are currently no economic rents in the member benefit administration industry. If anything, the pursuit of ever-finer margins by funds individually has given rise to a system-wide risk in Australia that the provision of member administration services is not sustainable at current fee levels.

What about asset management fees? This is more complex. Research in 2009 by Deloitte suggested that the fees paid by Australian funds for asset management are roughly commensurate with those paid in other countries, on a like-for-like basis. There is no reason to suppose that this conclusion is suspect, and indeed it coincides with the personal professional experience of the authors. However tax, liability and cultural factors cause Australian funds to be more attracted to equity investment than many of their international peers.

4 The data has been adjusted to reflect the fact that for structural reasons investment management costs in the retail sector are typically allocated as 'management' costs. These costs, less an allowance for the types of management costs other sectors report under this heading, have been reallocated under the investment heading for consistency.

Alternative investment techniques also tend to be more expensive, as is active management. So the risk-appetites of the trustees of Australian funds tend to drive fees up. Is this money well spent? That is hard to gauge definitively even analysing after-tax, after-fee ('net') returns. In order to answer the question you have to assess the success of funds' investment strategies each against their unique objectives because the regulatory scheme makes it abundantly clear that the trustees of superannuation funds are required to set an investment strategy that has regard for unique circumstances of the funds they serve[5]. So a simple comparison of net returns will not of itself tell you whether the fees paid and costs incurred were worth it; you have to know what the objective was. Moreover, statistical performance measurement is a notoriously 'noisy' business. You need a long time-series of observations (or very aberrant relative performance) to form any confident conclusions using statistical techniques when risk and estimation error are accounted for.[6]

Finally, the pricing pressures faced by member benefit administrators are also true of asset consultant, audit and actuarial services, but as the graph demonstrates, the quantum of those services are typically immaterial in the broader scheme of things.

So what does all this mean? We submit that the question of efficiency is too important to put in the too-hard basket. The success of the superannuation system in collecting, investing and returning monies designated to meet individuals' retirement expenditure is crucial not just for those individuals but for capital markets and for society as a whole.

Equally, though, the importance of the question does not mean that changes are urgently required. Again, with respect, the naivety of the Grattan report is distinctly unhelpful. In fact a number of processes designed to promote systemic efficiency have already been introduced.

Opportunities to reduce the costs of the superannuation system must come from one of three sources. They could come from re-configuring the architecture of the system to reduce the ability of the financial sector to over-specify the products it provides. This is one part of what the MySuper initiative is attempting to achieve. The jury is still out on whether that initiative will be successful in achieving that objective, but further regulatory changes at this point are unlikely to make success more likely.

Alternatively, cost reductions could result from price competition between service providers in some or all of the component services that are required to administer the system. There is research that tends to suggest that use of related service providers can in some cases lead to higher reported costs but the de-entrenchment provisions introduced by the Stronger Super reforms were specifically designed to address head-on those concerns. This is reinforced by the express reference in the s52(6) investment covenant to costs as a consideration for trustees in setting investment strategies. These provisions came into force on 1 July 2013 and must be given time to take effect given the lead-times in outsourcing re-negotiations.

Finally, cost reductions could come from more effective regulatory oversight. We note in that regard that the government's Statement of Expectations of APRA, released in April of this year, include a very clear direction from the government to reduce 'red tape and compliance costs' as a means to improve overall productivity. No precise guidance is given to APRA about how to prioritise different cost-cutting alternatives, but the broad direction is clear.

5 Section 52(6), Superannuation Industry (Supervision) Act 1993 (Cth). Also APRA, Prudential Standard SPS 530: Investment Governance, available at http://www.apra.gov.au/Super/PrudentialFramework/Documents/Final-SPS-530-Investment-Governance-July-2013.pdf.

6 Robert Ferguson, ''The trouble with performance measurement' (1986) 12 (3) The Journal of Portfolio Management 4.

In summary then, this submission seeks to remind the Inquiry of the importance of closely focused and evidence-led analysis. Views such as those propagated by the Grattan Report are unhelpful not so much because they are incorrect but because the analysis on which they rely is on the superficial side and as a result cannot generate concrete and implementable recommendations for change. Our analysis should not be taken to suggest that there are no opportunities further for cost-efficiency in the system; rather that more granular analysis is required to identify them and, in any case, there are initiatives already in place that will promote the discovery and elimination of some of them. A fairer, more efficient superannuation system will benefit all Australians.

Yours sincerely

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