Are administration and investment costs in the Australian superannuation industry too high?

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November 2001

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Executive summary and key messages

- A number of studies have significantly overstated the average costs and fees of Australian superannuation funds. New research from the ASFA Research Centre drawing on both official and survey data provides a more accurate account of the level and distribution of fees and charges.

- The average cost of administration and investment in superannuation funds in Australia is around 1.3% of assets, with only a small minority of fund members (less than 3%) with compulsory Superannuation Guarantee (SG) contributions facing fees and costs in excess of 1% of assets.

- This is a very competitive outcome by world standards.

- The competitive nature of the fees and charges is particularly significant given the smaller $ balances, relative to many other countries, held by many individuals in Australia – particularly in industry funds.

- However, a minority of funds and fund members face fees and costs which are high by the standards of best practice in Australia and overseas. These include some (but not all) retail funds. This is largely due to costs associated with distribution of retail products and the provision of advice.

- Contrary to common perceptions, many of the self managed funds face relatively high costs and fees despite the role of their trustee members.

- On the other hand, ASFA and APRA estimates suggest that the bulk of members are in funds with cost ratios below 1%, with some public sector funds having cost ratios of 0.5% or lower.

  Some, those in defined benefit schemes, are not directly impacted by fees at all.

  Retail products offered on a group basis often have expenses around 1% of assets. Retail products offered on an individual basis can have fees as low as 1% of assets for large balances, but generally have expenses in excess of 1.5% with expenses of 2.5% or more for small retail products distributed by way of an adviser or other network (see table 4.2).

- Recent initiatives to improve the operations of the Lost Member Register and to help consolidate accounts are welcome and would reduce the overall costs to individuals.

- Better and standardised disclosure is required to enable valid comparisons.

- In the absence of better disclosure there may be a case for tightening of other legislative requirements, especially in cases where there are limitations on moving from a fund.

- It would be undesirable and unsound practice to structure fees so that they relate to the annual contributions (rather than assets).

1. Introduction

In recent months there has been considerable public debate about the level of fees and charges which impact on, or potentially impact on, the superannuation entitlements of individuals. This is understandable. The price of financial services is of considerable consequence for fund members. Superannuation will be for most people their most important financial asset after their home. Not understanding properly the impact of charges can be very costly for consumers if there are different options with different fees as well.

In addition, the complexity of some fee structures can make it difficult and costly for individuals to collect information on fees and to make comparisons. While financial planners can assist with considering available investment options and superannuation strategies, very often their own remuneration is one of the complicating factors in comparing fees and charges.

Administrative and investment fees and charges are also of considerable interest to policy-makers because they can have a significant impact on eventual retirement income. Calculations prepared by one researcher have shown fees reducing eventual retirement savings by between under 10% to over 25%, depending on the fee level concerned. However, on the other hand there are some that argue that higher fees can be a reward for better performance in regard to investment earnings.

Member interest in fees disclosed on member statements is heightened during times when investment earnings are low, and fees appear to be relatively high. In many cases concerns are further increased by the impact of contributions tax. In this regard, it needs to be noted that often the most significant charge made against a member's account balance is the Commonwealth Government's 15% tax on employer contributions to superannuation (with sometimes the 15% surcharge tax on top of that for high income earners and those who do not disclose a tax file number). Insurance premiums for death and disability cover also can be perceived, incorrectly, by some members who do not make an insurance claim as being an additional charge for no additional benefit. That said, for some individuals and for some superannuation products the level of administration and investment charges can be relatively high in comparison to fund earnings.

Unfortunately at times confused and incorrect conclusions have been adopted by other commentators. Concerns about fees and charges have been expressed from time to time by consumer groups and by media commentators. For instance, the Australian Consumers' Association issued a media release on the topic on 1 November 2001 which claimed, amongst other things, that parts of the super industry are "creaming" a very nice profit off each member. Similar sentiments have been expressed by Alan Kohler in the Australian Financial Review in assorted articles, the latest of which was on 3 November 2001. Brian Toohey also is a regular complainer about superannuation charges, and other aspects of superannuation, in his columns in the Sun Herald and Australian Financial Review.

A third group of complaints comes from the superannuation sector itself, normally in the context of one fund or category of funds claiming to be much more cost competitive than other funds. Generally it is personal superannuation products distributed by for-profit financial institutions that are the target of such criticisms. For instance, a number of industry funds have published comparisons of their fees and charges with those of competing master trusts. The Australian Institute of Superannuation Trustees (AIST) also has made adverse comments on the relative level of charges of retail superannuation products.

The fourth and perhaps most worrying source of criticism of fees and charges comes from academic and other researchers. For instance, a report prepared by Dr Hazel Bateman of the University of New South Wales for AIST has received significant coverage since its release in August 2001.

Research has also been undertaken by a range of other finance sector and private sector economic research agencies.

In summary, a number of concerns have been raised about the level of superannuation fees and costs and their disclosure to fund members. This paper looks in turn at the evidence available in regard to fees and costs, both in absolute terms and relative to equivalent funds overseas, and at available qualitative and analytical research on nature and effectiveness of disclosure of fees in Australia.

Evidence on fees and costs in Australia comes from three main sources. The first is APRA survey and annual return data, the second is ASFA's survey of administration and investment costs, and the third is illustrative projections based on advertised or actual fee structures. Evidence on overseas fees and charges comes from both OECD and World Bank published studies.

2. APRA annual return and survey based estimates of costs

The prudential regulator for superannuation, the Australian Prudential Regulation Authority (APRA) publishes quarterly statistics drawn from a joint APRA and Australian Bureau of Statistics (ABS) survey. The survey covers the largest 370 or so superannuation funds in Australia, which account for the bulk of superannuation assets and over 90% of the members in the system. These data are supplemented by estimates of other industry components to fill out the picture and derive aggregate estimates. These other sources include the annual returns submitted by all regulated funds to either APRA or the Australian Taxation Office (in the case of self managed funds).

2.1 APRA estimates of aggregate fund operating expenses

The quarterly survey and APRA annual returns collect information on fund operating expenses, namely total administration costs and those investment management costs directly incurred by funds. The notes to this item on the annual return and quarterly statistical returns make it clear that where an investment is unitised or the like and investment charges are reflected in the rate of return, no attempt is to be made by the fund to include those investment costs in the item. In the case of retail funds, operating costs will generally include commissions paid to financial planners and the like.

Accordingly, the information provided should be reasonably comprehensive in regard to administration costs incurred by a fund, but for some funds little or no investment costs will be included because unitised and/or other investments which provide a net rate of return are used. That said, the APRA measure includes the bulk of aggregate superannuation fund investment and operating expenses.

The APRA estimates indicate total operating expenses of around $3,600 million in 2000-01, about 0.7% of relevant superannuation fund assets and around $155 per member account (Table 2.1).

Table 2.1: APRA estimates of administration and direct investment costs, 2000-01

Type of fund	Operating costs	Costs as a % of assets
Corporate	$281m	0.3%
Industry	$313m	0.7%
Public sector	$430m	0.4%
Retail	$1,231m	0.8%
Small funds	$1,325	1.5%
Total	**$3,600m**	**0.7%**

Source: Superannuation Trends, June quarter 2001.

As noted above, not all investment expenses are captured by the APRA investments as many funds have substantial investments made through investment managers, Pooled Superannuation Trusts (PSTs) and/or the statutory funds of life insurance companies. In regard to these investments, typically a net return is received after explicit or implicit deduction of investment charges by the manager or life insurance company. Table 2.2 sets out the percentage of assets directly invested by different categories of funds. The lower the percentage of assets directly invested, the higher will be the investment costs **not** captured by the APRA numbers.

Table 2.2: Proportion of assets directly invested, 1995 and 2001

Type of fund	**June 1995**	**June 2001**
Corporate	16%	19%
Industry	3%	32%
Public sector	63%	34%
Retail	12%	13%
Small funds	80%	82%
Total (excluding small funds)	**29%**	**22%**

Source: APRA and ATO estimates

When adjustment is made for investment management costs incurred outside the fund in managed investments, an increase in estimated operating costs is recorded. This is particularly the case for retail funds, where most investments are managed externally and with fund members often charged for this at retail rates. Table 2.3 sets out summary results. The level and pattern of the estimates are remarkably similar to those which have previously been derived from the ASFA survey of administration and investment costs and a range of other administrative sources (see Section 3, particularly Table 3.3). This consistency achieved in measures from quite diverse sources is something that researchers do not always encounter!

Table 2.3: APRA estimates of fund operating costs adjusted for external investment management costs, June 2001

Type of fund	**Costs as a % of assets**
Corporate	0.7%
Industry	1.0%
Public sector	0.6%
Retail	2.0%
Small funds	1.8%
Total	**1.3%**

Source: APRA estimates adjusted by ASFA Research Centre

The main significant difference from previously published cost estimates is in regard to the administration and investment costs for the self managed and mostly directly invested small funds. While a substantial proportion of individuals with self managed funds establish them because they want greater control and flexibility, many also believe that direct investing is cheaper because investment management fees are avoided.

However, the APRA figures in regard to the operating expenses of small funds indicate that they are more expensive to run than most other categories of funds, and are as nearly as expensive on average as the most expensive retail funds. While the costs of direct investment may be lower, there can be significant fixed costs for SMFs, equivalent to a percentage point or more of assets. Around 50% of SMFs have assets of less than $200,000, and fixed costs are often in the order of $1,000 to $2,000 a year, and sometimes more. Many Small APRA Funds face yearly charges of $5,000 or more, albeit usually on relatively high balances.

In summary, better data have cast doubt on what was previously conventional wisdom, or at least the aspirations in regard to fees and costs of many of those with small, self managed funds. The true costs of small funds have only recently appeared in the APRA aggregate statistics, as following the transfer of responsibility for most small funds to the Australian Taxation Office there is now much more comprehensive data available on those funds. APRA estimates of the operating expenses of small funds doubled with revised statistics released in the June Quarter 2001 Superannuation Trends publication.

2.2 Third party estimates of operating expenses based on APRA unit record data

Dr Hazel Bateman of the School of Economics at the University of New South Wales was given access by APRA to a unit record file of 1998-99 annual return data. While details that could be used to identify a particular fund were removed from the data file, otherwise it was more or less as compiled by APRA. She has produced two papers based on the data, one published in July 2001 for the Colloquium of Superannuation Researchers, and a second in August 2001 for the Australian Institute of Superannuation Trustees.

However, there are some inconsistencies between her July 2001 and August 2001 papers, the latter being the one that has been the subject of media attention. For instance, between July and August the estimated average annual administrative expense per member for 1998-99 had grown from $561 to $700 per member, with expenses as a percentage of assets leaping from 1.08% to 1.72% (Table 2.4). It is possible that the two papers have different populations of funds. There are indications that the July 2001 excluded relatively small corporate funds, but this should not have had a significant impact on the estimates if weighted averages were used. Like the data directly published by APRA, operating costs refers to fund administration costs and direct investment costs.

Table 2.4: Bateman estimates of fund operating costs

Type of fund	Costs as a % of assets (July 2001 paper)	Costs as a % of assets (August 2001 paper)
Corporate	1.0%	1.8%
Industry	1.27%	1.28%
Public sector	1.05%	1.10%
Retail	1.53%	2.13%
Total	**1.08%**	**1.72%**

In particular, the August 2001 paper has higher per member expenses for corporate and industry funds than the July 2001 paper, and much higher expenses as a percentage of assets for corporate and retail funds. In terms of expenses as a percentage of assets, the

August 2001 paper showed defined contribution funds having expenses of 1.98%, up markedly from the 1.21% in the July Bateman paper.

This pattern of differences is difficult to explain. Bateman in her August 2001 paper provides no information on why the results differ from the July 2001 paper, but Table 2 of the August paper suggests that it includes funds with less than $1 million and with fewer than 10 members which apparently were excluded in the July paper. The inclusion of these numerous (but not important in terms of total members and assets) funds appears to have imparted a large upward bias to the estimates.

The unit record file had the advantage of including a majority of the superannuation funds then in existence, and the vast majority of assets and member accounts in the system. Unfortunately, the data are now some two years old. Also a concern is the editing and checking process for the estimates, or more accurately, the lack of any real checking process for the data that are provided. While quarterly returns by large superannuation funds are checked by APRA and ABS staff for consistency and sense, no such check appears to be applied to annual return data other than by way of field audit. Even then it is not clear whether annual return data in APRA's system are amended as the result of the discovery of any errors or misreporting. ASFA is aware from comments by APRA statistics staff that there are substantial discrepancies between APRA annual return and survey data, and in annual return data for specific funds over time. Different staff in funds and administrators can fill in items differently.

The aggregates directly calculated by APRA from more or less the same data source as Bateman are much lower than the Bateman estimates (see Table 2.1). In the absence of any compelling reason to the contrary it is sensible to place more reliance on official estimates of the regulator rather than estimates prepared by a third party based on disaggregated data provided by the regulator. This is particularly the case if there are apparent limitations in the Bateman treatment of the data.

2.3 Limitations of the Bateman manipulation of the data

As noted above, there are both internal inconsistencies in the Bateman results, and between the Bateman results and aggregate data based on the same returns published by APRA. The Bateman published papers are not explicit on the nature of the averages presented, but it appears that most of the averages published are averages of the results for each fund within the study.

This has major limitations given that it appears the same weighting in the averages is given to a fund with 10 members as one with 200,000 members or more. Only about 0.5% of assets and members are in funds with less than $5 million in assets. However, Table 2 in the August Bateman paper indicates that while the annual administrative and investment expenses of funds with more than $5 million in assets are 1% or less, the overall average for the entire population of funds is 1.72%. This is grossly misleading.

On the face of the figures presented, 99.5% of fund members are in categories of funds where the average expenses as indicated by the APRA numbers are 1% or less (with some fund members below this average and some above). The 1.72% figure presented by Bateman and which has received widespread media coverage is irrelevant for the vast bulk of persons with superannuation. Use of this figure has led to, and will continue to lead to, incorrect conclusions and policy prescriptions being drawn.

The identical problem arises with the Bateman estimates of costs per member. The claimed average of $700 per member appears to be artificially inflated by the costs in the numerous, but relatively unimportant in terms of aggregate accounts and assets, corporate funds. A significant proportion of the latter are also defined benefit funds or funds where the employer meets the expenses of the fund. In neither case do the fund expenses impact on the benefit to the employee. Even if they were borne in full by the members of corporate funds then the higher costs for such funds should only be given the weighting of the share of members and/or assets when the overall average for the sector is being calculated.

This apparent use of unweighted averages for funds also leads to major inconsistencies if the percentages and costs per member are grossed up for the sector as a whole. Applying the $700 per member figure to the 19.7 million member accounts as at June 1999 implies aggregate administration and investment costs of $13.8 billion dollars. On the other hand, 1.72% of the $305 billion then in corporate, industry, public sector and retail funds is $5.2 billion. Aggregate figures on administration and investment costs published quarterly by APRA indicate aggregate costs of only $3.4 billion in the same year.

In summary, little reliance should be placed on the Bateman estimates, particularly the estimated averages for the superannuation system as whole. Averages presented for components of the system may be slightly more defensible, but also appear to be tainted by the use of averages which are not weighted by the number of members of the level of assets of each fund. This effect has particular impact for the estimates for corporate and retail funds where there is a large range in fund sizes. Unfortunately almost all public attention and debate has been on the averages presented by Bateman for the superannuation system as a whole.

The data set available to Bateman has some potential to provide information about the distribution of operating expense levels for funds of various types and sizes. Despite this, the bulk of the results she has published to date have related to averages, averages unweighted by assets or the number of members in funds at that.

3. Other surveys of administration and investment costs

ASFA Research Centre survey

In the first half of 2001 an email was sent to 300 ASFA members inviting them to participate in a survey of fund costs in the financial year 1999-2000. ASFA members are drawn from a broad range of fund in regard to both type and size.

Of the 300 funds which received the questionnaire, 60 completed surveys were returned. The survey responses covered funds responsible for $62 billion in assets, about 12% of the then overall assets of the superannuation system. Coverage by asset level was at around 32% for corporate funds, 16% for public sector funds and 54% for industry funds. This level of coverage is sufficient to provide a reasonable degree of statistical validity to the results for those sectors. Funds responding ranged in size from 250 members to around 500,000 members. As has been the case with previous surveys, no retail funds responded.

3.1 Aggregate administration costs

Table 3.1 below uses data from the 2001 ASFA survey of costs, together with other available data and estimates, to give an overall picture of administration costs in the superannuation sector. The data suggest that aggregate administration costs for superannuation funds in 1999-00 were of the order of $2.45 billion. While this is a considerable sum it has to be seen in the context of the 21.7 million accounts in superannuation funds and the $477 billion in assets in funds as at June 2000.

Table 3.1 Aggregate administration costs by type of fund, June 2000

Type of fund	Members at June 2000 (million)	Annual administration costs per member ($)	Total administration costs ($ million)
Industry	6.545	54	350
Corporate	1.437	147	210
Public sector	2.722	60	160
Retail (excluding RSAs and ERFs)	8.3	160(a)	1330
Retirement Savings Accounts	0.3	90(b)	27
Eligible Rollover Funds	2	15(c)	30
Small funds	0.415		400(d)
Annuities	0.25	150(d0	40
Total	**21.727**		**2550**

(a) estimated on the basis of June 1997 ISC estimates for master trusts, adjusted for both inflation and increased competition
(b) estimated by ASFA Research Centre
(c) APRA Bulletin December quarter 1998, adjusted for inflation
(d) Estimated by ASFA Research Centre

While retail funds of various types account for over half of the estimated administration costs of superannuation, this is largely a function of there being over 8 million retail accounts out of the total 21.7 million member accounts. The administration costs of Eligible Rollover Fund accounts are very low at around $15 per account per year, but the average administration costs of other retail accounts are higher than the average for the sector as a whole.

The higher costs of the bulk of the retail sector do not necessarily reflect any inefficiency given that the administration in most instances is carried out by the same or similar organisations that provide administration services for other categories of superannuation funds. However, providers of retail products take their profit in part by a margin on administration costs, and there also are the costs of maintaining a sales network and advertising for a large part of the retail product range.

Master trusts also generally offer a greater range of investment choices and can provide a higher level of reporting and transaction capabilities than other funds that are commonly used. Information from one of the major administration companies indicates that while there are typically 5,000 to 6,000 members per administration staff member for industry funds, the ratio is only 1,000 to 2,000 members per administration staff member for master trusts.

At an average cost per account of $110 per year and given multiple account holdings, which are common in the current system, costs can mount up for individuals and society as a whole. However, it should be noted that around 2 million of these multiple accounts are in Eligible Rollover Funds where the administration cost per member per year is only around $15. A significant proportion of multiple accounts are also in the relatively low cost industry and public sector funds, with each of these categories of funds having about a third of their accounts inactive. That said, consolidation of accounts has the potential to significantly reduce aggregate costs and to increase the retirement savings of individuals. Recent initiatives to improve the operation of the Lost Members Register and to aid the consolidation of account balances are to be welcomed.

3.2 Aggregate investment costs

The cost of investment management (expressed in terms of a percentage of assets) generally decreases with the total assets of each corporate, public sector and industry fund, although investment mix will also have an impact.

Table 3.2 uses a range of available data and estimates to give an overall picture of investment management costs in the superannuation sector. The estimates cover both the direct investment costs of funds and the costs incurred by use of external fund managers of various types. The data suggest that aggregate investment management costs for superannuation in 1999-00 were of the order of $3.1 billion.

Table 3.2 Aggregate investment management costs by type of fund, June 2000

Type of fund	Assets at June 2000 ($ billion)	Total investment costs ($ million)
Industry	36.6	145(a)
Corporate	77.3	390(a)
Public sector	110.4	380(a)
Retail – personal super	89	1510(b)
Retail – employer group plans	44	400(c)
Retirement Savings Accounts	0.5	5(d)
Eligible Rollover Funds	2	15(d)
Small funds	67.8	230(e)
Total	**427.3**	**3075**

(a) estimated using average MERs reported in survey, adjusted for under-reporting of costs of managed investments and for reported operating expenses in APRA quarterly bulletin. Assumed MER for industry funds is 40 basis points, for public sector funds it is 35 basis points, and for corporate funds 50 basis points.
(b) estimated on the basis of average investment costs of 1.7% per annum
(c) estimated on the basis of average investment costs of 0.9% per annum
(d) estimated by ASFA Research Centre
(e) estimated on the basis of average investment costs of 35 basis points per annum. The average reflects self managed fund use of both low cost direct asset holdings and relatively high cost retail investment products.

There are significant differences between wholesale and retail management expense ratios and investment charges. A large retail fund may have a considerable amount of assets in aggregate, and is in a position to achieve relatively low investment costs through use of in-house or external investment managers. However, it is customary for investment charges deducted from account balances to be based on individual account balances. In a significant minority of cases, a charge lower than retail rates but higher than wholesale rates will be applied when a member is part of a large group employer plan within a retail fund.

Where a master trust is delivered on an individual basis through direct distribution or by way of a financial planner generally a higher percentage charge is made than when an employer based, corporate master trust arrangement is used. However, the rate charged in regard to assets invested through a corporate master trust is variable, both between providers and between customers of the one provider. Published rates are often the starting point for negotiations when an employer approaches or is approached by a master trust provider. The larger the amount of contributions and assets the more negotiable are the outcomes. The approach taken by an employer to negotiations and the testing of other providers can also have an impact on the fee structure.

3.3 Aggregate administration and investment costs

On the basis of the preceding analysis aggregate investment and administration costs for superannuation funds were of the order of $5.6 billion a year as at June 2000 (Table 3.3). The table also calculates costs as a percentage of assets under management. Care should be taken in interpreting these percentages. Use of a particular type of fund does not necessarily lead to the specified percentage costs applying. For instance, the industry funds provide a very cost effective product for low balance accounts with regular modest contributions seeking a competitive return on the investment.

Lower charges might be possible in an ERF, but such funds do not offer scope for regular contributions or insurance cover and offer relatively low rates of returns in order to cover the costs of a large number of low balance accounts. Corporate and public sector funds may have lower cost ratios, but by definition such funds are not open to a range of employers and employers, and they also benefit from higher average account balances compared to industry funds. It is also important to note that larger balance accounts in industry funds will achieve a cost ratio lower than the average for the industry funds. The reason for this is that as the balance of an account grows, the fixed dollar administration charge becomes a smaller proportion of the account balance.

Equally, while many retail products are relatively high cost for both low and high balance accounts, retail products provided on a group basis through an employer can be relatively cost competitive. On the other hand, a significant number of smaller self managed funds will not achieve costs of less than 1% of assets of the fund because of the relatively high fixed costs associated with such funds. As with a number of the other types of funds, a relatively high average account balance is necessary to obtain a modest or low level of costs in terms of a percentage of assets.

Table 3.3 Aggregate administration and investment costs by type of fund, June 2000

Type of fund	Assets at June 2000 ($ billion)	Average account balance ($)	Costs as a percentage of assets	Total costs ($ million)
Industry	36.6	5,590	1.35	495
Corporate	77.3	53,800	0.78	600
Public sector	110.4	40,550	0.49	540
Retail	133	18,350	2.4	3240
Retirement Savings Accounts	0.5		0.65	32
Eligible Rollover Funds	2		0.23	45
Small funds	67.8	180,300	0.93	630
Total	**427.3**		**1.29**	**5625**

3.4 Other surveys of administration and investment costs

A variety of surveys of superannuation fund administration and investment costs and charges have been conducted over the last few years. Some of these have had a marketing focus, while others have been more general. Most have focussed on the retail and industry fund segments of the industry. Appendix A provides further details.

The various APRA and other surveys differ in their coverage and focus, but their findings are broadly consistent with the ASFA findings set out in the preceding sections. Overall costs are estimated at around 1.3% of assets, non-retail funds of significant size generally achieve costs of less than 1% of assets, retail funds offered on a group basis through large employers often have expenses of around 1% of assets. Public sector funds are generally shown as the lowest cost, followed by corporate and industry funds (although the markedly different average account balances can make comparisons misleading). Retail products offered on an individual basis can have fees as low as 1% of assets for large balances, but generally have expenses in excess of 1.5%, with expenses of 2.5% or more for small scale retail products distributed by way of an adviser or other network.

4. Fund operating costs faced by different categories of fund members

While the average costs for administration and investment across all funds are about 1.3% of fund assets, there is considerable variation in costs between categories of funds. Relatively few fund members face a cost structure of 1.3%, with most below and a minority above. As well, not all members actually bear the incidence of these costs given that some members are in defined benefit funds or their employer otherwise picks up the costs of the fund in whole or part. Clearly, when a defined benefit is involved it is the criteria which define the benefit that are important to the members, while the costs and investment returns are relevant to the funding requirement on the employer.

The relative importance of defined benefit funds is declining over time, but there are still significant numbers of members and assets in such funds (Table 4.1). While 86% of member accounts are in purely accumulation funds, only 56% of assets are in such funds. When the unfunded element of certain major public sector schemes is taken into account, the proportion of benefits attributable to defined benefit schemes is even higher. As well, in some accumulation funds the employer pays all or part of the running costs. This is especially the case in some larger corporate schemes.

Table 4.1: Members and assets by benefit design, June 2001

Type of fund	Percentage of members	Percentage of assets
Accumulation	86.4%	55.7%
Defined Benefit	2.1%	6.1%
Hybrid	11.4%	38.2%

Source: APRA Superannuation Trends, June quarter 2001.

Of those in accumulation funds where administration and investment costs impact on the member, most members are in categories of funds where costs as a percentage of assets are 1% or below, particularly if the account balance exceeds a very modest amount, such as $10,000.

As at June 2001, around 50% of fund members and 50% of assets are in low cost industry, corporate and public sector superannuation funds (Table 4.2). A further 12% of accounts are in very low cost Eligible Rollover Funds (ERFs). A further 2% of members and 18% of assets are in Self Managed Funds or Small APRA Funds, which have been established by the members themselves and which have the vast bulk of their assets directly invested.

It is difficult if not impossible to find an expensive industry or public sector fund. As well, the vast bulk (99% or more) of corporate fund members are in relatively low cost funds and/or funds where the employer pays the total costs in the case of a defined benefit fund or pays the administration and investment expenses in regard to an accumulation fund.

Out of the 38% of members and 32% of assets in retail funds other than ERFs or Retirement Savings Accounts, a significant proportion of such contributions will be voluntary and/or into moderately priced funds.

The bulk of contributions made to retail funds are voluntary in that they are after tax member contributions or contributions made by the self employed or owner managers of incorporated businesses. In terms of the overall composition of contributions to retail funds, around two-thirds are voluntary member contributions. Many of these contributions can be re-contributions of retirement benefits that have been received or other lump sums saved or inherited. It is unlikely that more than a very small proportion of member contributions are linked to employment arrangements.

A further 10% or so of total retail contributions are relatively low cost group contributions, and 15% or so are likely to be from the self employed, leaving less than 10% of total retail contributions as employer contributions which are made to meet Superannuation Guarantee obligations. Only about 3% or 4% of SG contributions are likely to be to higher cost retail products. As well, out of these SG employer contributions, a proportion would be in accordance with the directions of the employees concerned where the employer allows choice of fund.

The overall conclusion is that while there may be good fees and profits to be made from discretionary saving through superannuation, the pickings for the higher cost retail funds from compulsory employer contributions are relatively slim.

Table 4.2: Administration and investment costs for major categories of funds

Type of fund	**Percentage of fund assets**	**Percentage of accounts**	**Costs as a percentage of assets (ASFA survey estimate)**	**Costs as a percentage of assets (APRA quarterly survey based adjusted for external investment costs)**
Industry	9%	30%	1.35	1.0%
Corporate	17%	7%	0.78	0.7%
Public sector	23%	12%	0.49	0.6%
Retail	32%	38%	2.4(a)	2.0%(b)
Retirement Savings Accounts			0.65	
Eligible Rollover Funds	0.4%	12%	0.23	
Self Managed and Small APRA Funds	18%	2%	0.93	1.8%
Total			**1.29**	**1.3%**

(a) Around one-third of retail assets are in group employer master trusts with operating costs between 1.0% and 1.5%.
(b) Includes RSAs and ERFs.

5. Australian fees and charges relative to other countries

International comparisons are difficult. Both retirement savings products and methods of charging differ between countries. In some countries the remuneration of financial planners is bundled into the fees attached to retirement savings products, while in others the two are quite separate. Differences in distribution arrangements, the average size of funds, the maturity of the system, restrictions on entry, allowable range of investments, average account balances and target markets also complicate comparisons. There are numerous traps for both new and old players in developing comparable estimates.

Most of the difference between countries in fees and costs appears to be attributable to differences in costs associated with distribution. Administration activities and wholesale investment costs do not appear to differ markedly between countries, but there can be consequences from the average level of member account balances varying from country to country.

5.1 Wholesale investment costs

There is evidence that Australian investment costs for mandates in some asset ranges and classes are comparable to those in the United Kingdom and the USA. In those countries charges on investments of the order of $200m to $300m are usually of the order of 0.4% to 0.6% per cent for active managers or multi-manager specialist structures with different managers for different asset classes. Similar fees are readily available in Australia.

The existence of some very large funds in the UK and the USA leads to fees as low as 0.1% for huge mandates or index tracking. Australian funds would have trouble accessing fee levels that low, but they are able to achieve fees as low as 0.15% for passive Australian equity mandates. While fees for active mandates are higher, the managers of such mandates argue that they will generate additional returns sufficient to justify their fee. The empirical evidence available indicates that some but certainly not all managers can over a period of time outperform their benchmark by at least their fee.

Barriers to entry to funds management are relatively low. Where a funds manager makes use of a custodian for holding the assets that are managed or is a subsidiary of a major financial institution, no significant capital is required, and licensing requirements are not unduly onerous. There have been numerous boutique style managers set up business in Australia, and many multinational and overseas fund managers have offered their services in Australia or contemplated doing so. An overseas funds manager's initial entry costs might be no more than the salary and expense account for a business development manager, a mobile phone and a set of Powerpoint slides.

Given the absence of any significant barriers to entry, there is no real evidence of excess profits being made in wholesale funds management.

5.2 Running costs of funds other than retail funds

International comparisons of fund administration and investment costs are not easy to come by, but one source suggests that the range of costs for **defined benefit funds** in the USA is between 0.3% to 0.7%, and for **defined contribution funds** it is between 0.2% and 0.8%. ASFA and APRA estimates suggest that the range in Australia does not go quite that low, with the bulk of members in funds with cost ratios below 1%, with some public sector funds having cost ratios of 0.5% or lower. Differences in the scale of funds would appear to make the Australian funds slightly more costly on a percentage of assets basis. The relative complexity of Australian tax and regulatory requirements also would add slightly to Australian costs.

Industry funds in Australia tend to have costs that average a little over 1% of assets, but this is largely due to the relatively low average account balances of such funds at the moment. There is a certain minimum administration cost per member that has to be recovered, and while low in absolute terms such costs mount up to a reasonable percentage of the low average account balances. Even with the handicap of numerous, low account balance members the cost of industry funds is modest however expressed.

There is no evidence to indicate that any fund in another country could achieve significantly lower costs as a percentage of assets if they had to deal with average account balances of only $A5,000. It also should be noted that the ratio of costs to assets will come down for industry funds as the average member balance increases. The current cost ratio is more a reflection of the state of maturity of the compulsory system than an indication that industry funds could be more efficient.

In a number of other countries which appear to have lower average costs, average balances tend to be much higher than those currently in Australian industry funds, and in the few countries where there is a high volume of low balance accounts, expenses tend to be higher than in Australia. For instance, Chile, which has compulsory contributions at the rate of 10% of wages and fewer than 20 providers in the market, is not particularly low cost. The World Bank in its 1994 publication *Averting the Old Age Crisis* suggests that running costs in Chile are 2% or so of assets, and were much higher than this in the early years of such funds. Other South American countries also have had relatively high cost ratios in the early years of their compulsory schemes, ratios much higher than those applying to Australian industry funds.

These observations are confirmed by published estimates of average charges per member across a range of countries and funds (Table 5.1). Differences in average balances and other industry practices complicate comparisons, as do exchange rate oddities, but the pattern is reasonably explicable. While not calculated in the table, the comparable figure for a member of a retail fund in Australia in 1999 would have been $US160 for a member facing charges equivalent to 2% of a $12,000 account balance. A member in a group employer master trust would have faced charges lower than this.

Table 5.1: Charges per member or contributor per year in $US terms

Country and fund	Charges per member or contributor ($US)
AFJP Argentina	239
PPP Great Britain (1994)	229
APFP Peru	193
AFPC Colombia	192
AFAP Uruguay	140
AFP Chile	127
AFP El Salvador	93
AFORE Mexico	78
Industry Fund Australia	78
Equity Index Fund USA (1995)	68
AFP Bolivia	25

Source: Valdes-Prieto, 2001

5.3 Running costs of retail funds

The area in which Australia generally does not rate so well in international comparisons is in the provision of retail managed investments, including super, distributed on an individual basis. The total costs of such products are typically of the order of 2% of assets, and there are some older and less competitive products which have even higher costs. As noted above, this places such funds towards the top of Table 5.1, but some countries have even higher charges.

However, not all of the retail sector in Australia has high charges, and there are other countries with higher charges. Retail accounts for over 30% of total superannuation assets, but around a third (and growing) of retail superannuation involves group, employer facilitated arrangements. For many, the latter arrangements cost around 1% or less, particularly where a medium or large employer is involved and/or where average balances are larger. Fees and costs tend to be higher than would be the case for comparable balances in corporate and industry funds, but the master trusts often provide additional services which may or may not be valued by the members concerned.

Other countries have retail products which are as expensive as the most expensive Australian retail products. For instance, many personal pension products in the UK have had expense ratios of 2% or so, as have pension compulsory arrangements distributed in Chile and other South American countries. Mutual funds in Chile outside the compulsory system have annual fees of around 6% for equity funds and 2% for bond funds.

However, it needs to be noted that in the UK the introduction of stakeholder pensions have led to substantial changes in the retail market. Although stakeholder pensions are distributed on a more or less group basis through employers, the cap of 1% on their total costs has tended to flow into other retail pension products. If employers are required to offer a low cost stakeholder pension plan it is hard to sell a private pension plan at higher cost in competition. That said, the extent of the adjustment that has been required by the introduction of stakeholder pensions has been smaller than some might think. Cost reductions in product design and distribution that have been facilitated by the introduction of stakeholder pensions appear to have been just as important as the legislated cap on fees. Many of the products it replaced had fees equivalent to only 1.2% or 1.3%, and there are cost savings for providers through simplified regulatory requirements and distribution principally through group arrangements with employers.

It is commonly asserted that retail cost ratios tend to be around the 1% mark in the USA. While this may be true in some cases, in others it can be more a measurement issue than a real cost saving. For instance, some USA retail products also have a high entry fee (up to 5%) which is paid by the member but does not necessarily end up in the calculated management expense ratio. In Australia adviser remuneration is more likely to end up in the expense ratio of retail funds because of the entry and trail commissions that are paid by the fund.

As well, there is a considerable variation between individual retail products in the USA market, with some products having very low costs and fees, and others which are more in line with the pricing structure of products offered in the Australian market. When a passive fund is used and/or there is direct entry to the fund without involvement of an adviser or broker, ongoing charges can by 1% or less in mutual funds in the USA. However, while the USA has some mutual fund retail products that are low cost and have achieved significant levels of market penetration, there are other mutual fund products not dissimilar in form to Australian products and with similar, but slightly lower, fees.

As indicated by Table 5.2, once allowance is made for all fees incurred by investors in USA mutual funds, the average cost ratio in 1997 varied from 0.31% for a passive domestic bond fund to 2.38% for an active emerging markets fund. The overall average for retail funds weighted by assets was 1.52%, which is not particularly cheap by United Kingdom or even Australian standards. It also should be noted that these estimates are for an average account balance of $US25,000, which is relatively high by Australian standards. For a balance of that amount, Australian industry funds would be relatively cost competitive with even passive USA mutual funds.

Table 5.2: Average total investor costs for USA mutual funds, 1997

Type of fund	**Active**	**Passive**
Domestic shares	1.55%	0.37%
Domestic bonds	1.36%	0.31%
International shares	1.89%	0.48%
Emerging market	2.38%	0.63%
All funds	1.52%	0.37%

Source: James, Smalhout and Vittas in *New Ideas about Old Age Security*, The World Bank, 2001.

Australian master trusts also have been characterised by some commentators as being relatively expensive by world standards, but it is not hard to find fee levels which are equivalent in the USA. For instance, The October 2000 report on Wrap and Managed Account Issues prepared by Cerulli Associates indicates a typical asset-based fees for a mutual fund wrap of 1.25%. This fee covers client profiling, account monitoring and portfolio rebalancing. Mutual fund fees would be on top of this. Where customised investment management, rather than use of a standard mutual fund, is provided by way of a consultant wrap, the asset-based fee can reach 2.5% to 3%. However, such services when provided on line over the Internet have fees between 1.35% and 1.75%.

The USA also has wrap solutions provided by third part vendors which are very similar to the wrap platforms made available by certain Australian financial institutions for badging by advisory groups. The pricing in the USA for such products is between 0.4% to 1.3%, depending on vendor and services provided. Australian providers of wrap platforms are or could be comfortable with fees of this order.

In summary, while there are more low cost mutual fund options in the USA market than in Australia, the average fees paid are not that dissimilar when the full range of investor costs and the range of mutual fund products are taken into account. Australian pricing structures also differ from the USA in that while no-entry-fee products are available or can be negotiated in Australia, generally it is not possible to obtain a rebate of trail commissions built into almost all retail products. As a result, the dispersion of fee levels in the USA is higher than in Australia, but the overall average is not that much different.

That said, a number of USA based providers are envious of the profit margins some retail products achieve in Australia. These products typically are those directly distributed, amongst other methods, but which have an entry fee and trail component built into their pricing. However, only a few retail organisations in Australia have a brand image strong enough to attract business on those terms. For most overseas entrants to the Australian market the options usually are to pay commissions to financial planners and/or purchase an existing retail network.

While there has been some growth in relatively inexpensive index products, this has been from a low base. Financial planners remain the gatekeepers to entry to most retail investment products, and they have a strong preference for active managers. The volume of sales of such products also has not been sufficient to support the very slim pricing margins common in the USA.

5.4 Projections of different fee structures and levels

Bateman in her August 2001 paper presents international comparisons based on the calculation of the cumulative reduction in retirement accumulation that flows from the published fee structures. While these calculations are a little novel in Australia, such calculations have been prepared by a number of researchers active in international pension research within the context of the OECD, the International Monetary Fund and the World Bank.

The main advantage of such calculations are that a variety of fees, charges and costs can be transformed into a single number (or "metric" in the jargon of the researchers concerned). This can be desirable from a researcher's point of view when there might be a Byzantine set of fee schedules which involve various entry, ongoing and exit fees that might have both flat rate and percentage of assets elements.

However, reduction of accumulation estimates suffer from a number of limitations. They do not work well for defined benefit funds. They also do not work well in the case of not for profit funds, which are the majority in Australia, where it is the level of actual costs that is important rather than any projection forward of current costs. If costs do not rise in line with an increase in assets, or do not do so proportionately, then there is more net earnings for the member (or lower cost for the employer sponsor in the case of defined benefit funds).

The methodology also assumes that current fee structures are sustainable for periods as long as 40 years or more, even though costs are likely to rise in the future with an increase in assets under management. For instance, the table presented by Bateman makes Australia look expensive in terms of charges compared to centres of excellence of the managed funds world such as Bolivia, Peru and Colombia. However, the low cost of their systems is more apparent than real. Currently they charge fees only on contributions, and not on assets. If they can keep this up both in terms of not increasing the fee on contributions and charging no fees on assets, then the funds in their countries will be cheap for long term investors, particularly those who stop making contributions. They are expensive in the short run, but supposedly become cost competitive in the long run. They are the funds management equivalent of children who promise to do the washing up tomorrow in return for having sweets today. Not every parent is brave or silly enough to agree to such a deal.

One needs a degree of faith to believe that a system which relies on contribution charges only will be viable in the long run. There are costs which are related to the volume of funds, and already costs in the South American countries are equivalent to 2% or more of assets. As well, allowing no recovery of costs in regard to accounts where contributions are not being made does not provide any incentive or even a proper capacity to manage those assets well and achieve the highest return possible. Cost comparisons should be made on actual costs, rather than hypothetical illustrations of what might occur if a fee structure is sustained for a very long time.

In fact, once adjustment is made for different charging structures and practices which are specific to individual countries, there is not that much difference in the cost structure of retail products. This is not surprising as often it is the same multinational financial institutions that are selling the products in each country. However, costs and charges do tend to be lower in countries where a larger proportion of the retirement savings plans are distributed on a group basis. Individual advice and personal distribution (door to door or otherwise) comes at a cost. Foreign fund managers have found it far easier to operate in Australia by attracting business at the wholesale funds level by parachuting in a business development manager with a firm handshake and a set of graphs than by attempting to set up a low charge product for retail distribution.

6. Policy responses to concerns about the level of fees for retirement savings products

Public policy concerns about levels of fees and costs for retirement savings products fall into two main categories. The first relates to a desire by governments for better private retirement income adequacy and with subsequent possibly lower government expenditures on retirement income. To the extent that administration and investment costs are higher than they could be, this is a deadweight loss in the system. Lowering costs improves both adequacy and lowers demands on government.

The second group of public policy concerns relate to consumer protection and the exercise of market power in situations where bargaining power may not be equal and the costs of products are not easily compared. Consumer protection concerns can be intensified when a complex product is being provided by a large and powerful financial institution, and there is a need to rely on expert advice. Full and effective disclosure is often a major element of consumer protection, but in some countries and at some times further controls and requirements can be put in place for certain products.

Price control is in fact quite unusual in Australia and in most free market countries. Provided there is appropriate disclosure about price and the product provided, there generally are no restrictions on prices that can be charged other than the disciplines of the market. For instance, there is no prohibition on expensive restaurant meals even though you can eat more cheaply at home, or on cleaning products sold through multi-level distribution networks rather than at a local megamarket. However, if there is a compulsion to purchase a good or service the arguments for price control become stronger, especially if there are restrictions on the suppliers to be used.

The remainder of this chapter examines current and possible policy responses to concerns about the level of fees and charges applying to retirement income savings.

6.1 Improving disclosure

In contrast to some financial sector bodies, ASFA has campaigned for a considerable period of time for standardised and better disclosure of fees, charges and costs. In particular, ASFA strongly considers that the disclosure requirement for superannuation must be devised in a way that acknowledges the special nature of superannuation. Any disclosure requirements must recognise that superannuation is compulsory and therefore many people who become superannuation fund members may be financially unsophisticated.

The issue of disclosure regarding fees and charges has increased in its importance given the provision of choice of funds in many work environments – together with the government's intention to introduce choice of fund legislation. Superannuation choice forces most people to come to grips with super issues and decisions, including the need to compare products.

For many years, the main retail disclosure documentation requirements have been set out in the section 153 Determination for Key Features Statements (KFS). This has, in the view of ASFA, been an impracticable device for setting disclosure standards. There has been little consumer testing of the requirements and it has been driven by regulator and compliance, rather than consumer, demands. Accordingly, in mid-2000 ASFA undertook a project to consumer test disclosure documentation. The research was commissioned through Ageing Agendas and developed in consultation with all sectors of the superannuation industry along with bodies such as the Australian Consumers' Association. Its focus was on helping to construct more useful and user friendly disclosure material.

The research involved a range of aspects of disclosure:

- testing for jargon and then revising terms used;
- comprehension assessment of fees and charges; performance; and insurance coverage and terms; and
- ability to compare products.

Appendix B provides further details on the research and its conclusions. In broad terms, its conclusions were as follows:

- In a consumer choice environment, the disclosure model for superannuation products must ensure comparability of information as well as basic understanding of the material provided.
- The results of the comprehension testing indicate that a high degree of regulatory prescription is likely be necessary to achieve the twin aims of comprehension and comparability.
- An extensive consumer education program is required around each of the main themes or issues covered in the disclosure document, such as fees and charges, investment choices and performance, availability of insurance, and how to compare such information from different funds.

6.2 The impact of the Financial Services Reform legislation on disclosure

Following years of languid discussion and a few heated weeks of compromises, the *Financial Services Reform Act 2001* (FSR) received Royal Assent on 27 September 2001. FSR is a major reform, amending the Corporations Law and intended to create a single licensing and disclosure regime for most retail financial services and products, including superannuation.

FSR provides additional consumer protection including standardised product disclosure. This will mean most financial product issuers, including superannuation funds, will need to prepare and issue, in accordance with Corporations Law, a new disclosure document, the Product Disclosure Statement (PDS). Practically all APRA-regulated funds, including non-public offer funds that may be exempted from FSR licensing, will have to meet this new requirement.

The product disclosure requirements for new and prospective members will change dramatically under FSR, with the PDS to effectively replace both the member booklet issued by funds that are not public offer, and the Key Features Statement issued by those that are. The content of both will change, particularly in regard to the disclosure of fees and charges.

Once a fund becomes subject to the arrangements, a new standard-employer sponsored member has to be given the PDS within 3 months of joining the fund, while for new public-offer members (basically the members of retail funds and some major industry funds who do not have an employer sponsor) the requirement is that they be issued the PDS prior to joining the fund. The PDS is required to contain a range of material, ranging from contact details of the fund to the extent a range of ethical and environmental considerations are taken into account in selecting or retaining investments. However, for the purposes of this paper the provisions relating to disclosure of fees and charges and calculation of the ongoing management charge (OMC) are particularly relevant (Box 6.1). Funds have to fully disclose all remuneration, commissions and fees to members, and to calculate their OMC in the prescribed manner.

Box 6.1: Calculating the Ongoing Management Charge (OMC)

The ongoing management charge for a year of income of a superannuation fund is ***MC*** divided by ***AV***.

AV is average value of the net assets of the fund during the relevant year, calculated with regard to each valuation made during the year by the fund.

MC is the total amount of ongoing management charges charged for the relevant year of income, excluding the amount of charge paid or payable by a standard employer-sponsor of the fund (this latter exclusion might mean than defined benefit funds may not have any ongoing management charge as such if all charges are paid by the employer).

Charge in this context means most charges made by a trustee, service provider or other person against a member's benefits or against the assets or investment earnings of the fund. Exceptions include a contribution charge, death and disability insurance charge, exit charge, switching charge, or charge for a service requested by the member. It also does not include a government charge, tax or duty, or brokerage, maintenance of a property investment, or stamp duty on an investment transaction.

If the underlying investments are managed by a person, persons or organisation other than a trustee of the fund or an employee of the fund and a charge is deducted from the investment return before the amount of the return is worked out and paid to the fund, then a charge must be included in ***MC*** in respect of those investments. If the trustee cannot determine the amount of the charge, the trustee must make a reasonable estimate of the amount.

There is some uncertainty as to the operation of this provision. Where it applies to an investment by a superannuation fund in a managed investment scheme that itself has a clearly defined and disclosed management charge, the provision is straightforward. However, its application to fund investments such as bank term deposits or life insurance company investment policies or bonds, its operation is less clear. Hopefully purveyors of investment products will disclose management charges where appropriate

6.3 ASFA views on the FSR changes to disclosure

The ASFA commissioned research and comprehension testing of disclosure documents clearly indicates that there is a need for standardised, simple and uncluttered presentation of information that can be interpreted easily by a lay person and that makes comparison of products possible. A number of the new disclosure requirements do not meet these objectives as well as they possibly could.

For instance, the ASFA research highlighted that in regard to the comparison of fees the use of percentages in fee information is a barrier to understanding, whether consumers are considering one fund only, or making comparisons. Dollar illustrations are an essential element in comprehension and assessment. Given that different individuals will have different time horizons, these illustrations are best done for a variety of time periods. The time periods that were considered meaningful are generally in the range of 3 to 15 years.

The FSR regulations place their primary emphasis on percentages. While a dollar illustration for an account balance of $10,000 is also given, this is more an arithmetical calculation than an illustration. While not without ambiguity, the regulations appear to apply the standard calculated OMC percentage to the sum of $10,000 rather than requiring the calculation of what the fees and charges would actually be for a member with an account balance of $10,000.

The use of fee illustrations for various periods of fund membership as suggested by ASFA would allow any entry or exit fees to be taken into account, unlike the FSR regulations which exclude them entirely from calculation of the OMC. Disclosure also has to meet the needs of individuals with different levels of current account balances and prospective contribution and fund earnings periods. Fee illustrations would also assist in dealing with newly established funds with no real history of ongoing management charge. While newly established funds are still required to disclose relevant fees and charges deducted from member accounts, a simple illustration of the total impact would be far more effective.

The earlier part of this paper also identifies and compares the investment costs associated with different funds but some difficulties emerged in their comparability. Investment returns and fees are or can be positively correlated. A passive investment in government bonds involves much lower costs than active management of a domestic and international share portfolio. What might be a reasonable charge for active investment might be very expensive for a passive portfolio. The provision to consumers of benchmarks of investment performance can be just as important as information about investment management costs.

The disclosure requirements in the FSR legislation go someway to meeting the needs that have been identified by the ASFA research. However, there is a need to improve the illustrative examples provided, including by calculating the impact of entry and exit fees.

6.4 Limits on the number and types of fees that can be charged

Part of the difficulty in understanding and comparing fees and charges comes from the complex fee structure of some superannuation funds. Retail funds in particular often have many layers of charges, with some arguing that this reflects the costs and market environment of such funds, with others arguing that such practices are designed to conceal the total impact of fees.

In some countries the response has been to limit the number or type of fees that can be imposed. There are generally two basic options for a single, proportional charge of some kind. These are either a fee related to assets or a fee related to contributions.

Limiting the type of fee that can be charged can have other effects in addition to reducing complexity. For instance, a levy on assets has a different time profile of incidence than a levy on contributions. For a given level of fees over the life of a retirement savings plan, a contribution-based fee is "front-loaded", with fees heavier in earlier years than an asset based charge.

Table 6.1 illustrates the equivalent asset and contribution based fees using arrangements in Chile, one of the countries that requires only contribution fees to be applied. Limiting fees to contribution fees only tends to favour contributors with long fund membership and/or those who make contributions infrequently and early. Non-contributing members in effect pay no fee at all.

Table 6.1: Annual asset-based fee equivalent to a 15.6% contribution fee

Starting age	Contributions made for one year only at given age	Contributions made for 20 years only, starting at given age	Contributions made every year until age 65
25	0.45	0.57	0.76
35	0.60	0.85	1.05
45	0.91	1.65	1.65
55	1.86		3.50
64	33.37		33.37

Source: James, Smalhout and Vittas, 2001

The public policy grounds for a contribution fee only regime are pretty shaky. Contribution fees at a significant level bring about a large front-loading of revenue for providers of retirement income products. Some faith is required in the capacity and willingness of such providers to manage assets at a very low charge later in the savings cycle.

Concentration on contribution fees only can bring about undesirable behavioural responses by suppliers. There can be concentration on competing for new contributions, and then very little incentive to manage assets in a way that gives the highest returns. There also can be high costs/barriers to rolling money into another fund and/or making large lump sum contributions in the latter part of a member's working life. The competing for new contributions using commission based salespersons and questionable marketing tactics is observable in the South American countries that have adopted contribution fee only regimes. Time will tell whether the second set of problems will occur.

The contribution charge only also works best in systems which are starting from scratch, and for members with long periods of contributions. In countries like Australia where large amounts have been built up under other fee regimes, a transition to a contributions only regime would be very difficult. As well, a contributions only regime does not work well with lump sums which are contributed near retirement. Rollovers from public sector and corporate funds would also be treated inequitably and inefficiently under a regime where only contribution fees were permitted.

So far as Australia is concerned, there appears to be no compelling reason to limit fees to one type only. There is strong empirical evidence that costs of funds vary with both the number of members and the level of assets of a fund. It is generally both equitable and efficient to have both a flat rate charge per member in conjunction with an asset based charge. Whether the actual level of charges is appropriate is more a matter for disclosure and consideration by the member or employer deciding on the specific superannuation arrangements.

However, there is a case for better disclosure when there is a multiplicity of fees. This might be by way of illustrations, as suggested by the ASFA research referred to in section 6.1. It also might be achieved by requiring various fees to be added up. For instance, if there are multiple fees related to assets, then it is arguable that there should be a requirement to present the total asset based fee. Entry and exit fees are hard to express as an annual percentage of assets, but a standard formula could be used to calculate the impact over a specified period, say 5 or 7 years reflecting that most investments are rolled over or otherwise moved prior to maximum or contracted retirement age.

6.5 Reducing the costs of superannuation funds

A range of measures are available which might potentially reduce the operating costs of superannuation funds, although other costs might be incurred.

Simplification of tax and regulatory measures can have a favourable impact on costs and hence charges to members. Such changes accompanied the introduction of stakeholder pensions in the United Kingdom, and helped providers keep within the cap on fees that has been applied.

ASFA would support measures undertaken by the Government to simplify superannuation regulation and taxation. This would both reduce costs and improve member general satisfaction with the system.

Other cost control measures adopted in at least some countries are more contentious. Limiting providers to those that succeed in a competitive tender or are able to operate within a stringent fee cap has been adopted in some South American countries and in Sweden. Some other countries go further and have a centralised national fund.

While a large, centralised fund may achieve lower investment management costs, in practice this has been at the expense of investment returns. In a World Bank study, Iglesias and Palacios, 2001 conclude from a study of 22 major countries with centralised funds that half of the sample held risky portfolios and achieved dismal returns, while the other half had stable but low returns. These are not inspiring outcomes. While theoretically centralised funds should be able to replicate private sector fund manager performance, in practice political and institutional influences appear to condemn central, public sector funds to poor returns . Investments tend to be channelled into worthy but low return activities, or into government bonds. Even worse, investments by some central funds can be in speculative areas with only limited control over risk exposures.

In Australia, considerable thought was given to the costs and benefits of having a range of providers able to be used to meet Superannuation Guarantee obligations. At no stage has there been any serious consideration given to limiting the options available to individuals for discretionary savings. Whatever the merits in other countries for limiting choice of provider, you would "have to be dreaming" to consider any such option in the current Australian context. The existing approach works well, and no Australian government would go down the path of severely limiting the number of potential providers.

6.6 Reducing costs through consolidating accounts

In the year 2000 an ABS survey of households suggests that there were some 7.6 million persons employed with superannuation coverage, with a total of 8.5 million of those aged 15 to 69 years with super. A further 721,800 of those who had retired had received a lump sum or were currently receiving superannuation income. These figures suggest that the average number of accounts per person is around 2.6. This average has been creeping up over recent years.

The retail sector accounts for a fair proportion of the duplication, with around 11.5 million accounts, which is more than the number of persons with super. Account duplication either can be voluntary or unintended. Some individuals will choose to have more than one account in order to have exposure to different investment styles and services, while others will be aware of the existence of more than one account but may not be motivated enough to consolidate into one account. Other duplications are less voluntary. Nearly 3 million accounts are in Eligible Rollover Funds as a result of transfers by funds of small balance, inactive accounts. These often can involve members who have lost touch with their fund, and may even have left the country.

There is also considerable account duplication attributable to public sector schemes, particularly unfunded schemes where there are requirements to preserve entitlements until preservation age. Some funds have tens of thousands or even more of such members. A very small number of industry funds also restrict transfer out of account balances until a member satisfies a condition of release or demonstrates that they have ceased employment in the industry concerned.

Clearly, costs in the sector would be lower if there were fewer unwanted duplications of accounts, as each account involves unavoidable expenses. However, it should be noted that some of the duplicate accounts are in relatively low cost parts of the industry such as Eligible Rollover Funds. While some public sector schemes are fully funded, some duplicate accounts are in unfunded public sector schemes where governments may be unwilling to provide actual money to permit the rollover of a preserved benefit, or will provide such funds only on a one-off basis. The governments concerned also usually cover ongoing administration and investment costs, albeit at times offering implicit or explicit investment returns which are below general market rates.

That said, it is clear that the current arrangements which are aimed at reducing the incidence of duplicate accounts could be made to work better. ASFA suggestions include:

- requiring employers to make SG payments at least quarterly.
- imposing penalties on those employers who do not provide adequate data to the fund or who do not provide Fund contact information to the employee.
- changing the law so that backpackers and other short term residents can transfer out retirement savings to appropriate overseas funds.
- supporting wider use of the Lost Members Register (LMR) by funds, particularly by the use of electronic data interchange protocols between the ATO and funds that would allow funds independently to match members with the LMR.

Initiatives in a number of these areas have been foreshadowed in the recent superannuation election policies of the Government and/or are currently being discussed with the ATO.

6.7 The impact of increased competition on fee levels

International evidence as to whether increased competition leads to lower fees is equivocal. Both the size and the timing of any such impacts are uncertain. Any movement to lower cost and higher performing funds generally occurs through the flow of new money to funds, rather than the reallocation of old money. This is because of both investor inertia and the existence of exit fees and other transaction costs. Generally, investors in most countries have been slow in participating in lower cost options.

There are likely to be a number of reasons for this. Competition through marketing rather than through price cuts may be a rational response by providers in the absence of well informed consumers. Such tendencies may be reinforced by financial planners acting as the gatekeepers to a significant proportion of discretionary investments at the retail level. Competition in this context may involve the selection of products with actual or potential additional features, or a claim of prospective future performance which is better than a given benchmark or other investment products in the market. In addition, where a financial planner is remunerated by a trail commission of 40 points or more, that itself can be a barrier to the selection of low cost investment products.

As a result funds will spend money on marketing, pointing to what may be lucky or unrepeatable returns and/or to the superiority of their product due to reporting, investment choice and transaction features. In some countries, such as the United States, competition leads to the offering of relative low cost, high performing funds. In others the results of competition will be enhanced marketing rather than price competition. This arguably has been the case in some South American countries.

In both cases the existence of competition will largely eliminate any excess profits or monopoly rents on the part of providers. In the case of price competition this will be because fees decline, while in the case of marketing competition it will be because costs increase.

6.8 The imposition of a cap on fees

The imposition of any cap on fees that could be charged to a member by a superannuation fund would involve considerable controversy. It would have an impact in particular on retail superannuation funds. Many such funds and their sponsoring organisations would argue that the bulk of superannuation money invested has been undertaken voluntarily by members. If there has been appropriate disclosure and agreement, then there is no real public policy grounds for intervention.

However, the existence of compulsory employer contributions for most employees in conjunction with employer choice of fund in many instances does change the equation. The superannuation industry has accepted that in the case of low balance accounts receiving Superannuation Guarantee contributions, fees and charges (other than those for taxation or insurance) should not be allowed to erode the account balance. Accordingly, ASFA joined with the ACTU and the then Life Insurance Federation of Australia to propose to the Government that such accounts be member protected when the balance was $1,000 or below. The then Government accepted those arguments and implemented member protection.

Member protection is not costless, either for funds or indeed members. It needs to be recognised that this measure has brought with it considerable extra costs to funds and has in many instances required cross subsidies from members with higher account balances. The protection of small balances from fees may also have reduced the priority for some individuals in consolidating multiple accounts.

Any further extension of member protection or caps on fees would need to be considered very carefully given the implications for both funds and fund members.

Appendix A: Other surveys of costs and fees

A.1 KPMG survey of public offer funds

Around two times a year KPMG calculate the administration cost as a percentage of assets for superannuation provided to a sample small, medium and large employers. The survey results are available from the KPMG website. Only public offer funds with greater than 5,000 members or $50 million under management are included. Investment costs are intentionally not included, and when a fund has an asset based management fee that does not split out investment costs it is assumed that a fee of 0.7% applies for a balanced option.

The KPMG survey results indicate that for small employers (less than 50 employees) for profit retail providers generally have an administration charge a little over 1% and below 1.5% in all of the funds surveyed. Industry funds in the survey had administration costs as low as 0.2%.

For large employers (more than 600 employees) the industry funds remain at cost ratios below 0.5%, with most for-profit providers coming in between 0.5% and 1%. A few for-profit providers had cost ratios below 0.5%.

Investment costs are on top of these administration costs. While not in the KPMG survey, other sources indicate that for an industry fund investment costs might be 0.4% of assets or less. For a large scale retail fund utilised by a large employer the investment cost might be around 0.7% for a balanced option of the retail provider. Where outside investment managers, multiple investment choices and/or smaller employer plans are involved the administration charge generally will be in excess of 1%, and can approach 2% in some cases.

A.2 Estimates prepared by Phillips Fox Actuaries and Consultants (PFAC)

PFAC have prepared a number of cost estimates for the Investment and Financial Services Association. Table A.1 provides summary details.

Table A.1: Average costs by major fund type

Type of fund	Costs as a % of assets
Corporate	1.1%
Industry	1.5%
Corporate master trusts	1.64%
Retail	2.1% to 2.4%
Total	**1.3%**

PFAC have also prepared a summary of some recent corporate master trust tender offers to employers (Table A.2). This data includes all fees (entry, ongoing and exit). With total fees at around 1% or less these tender offers are less expensive than the standard large employer deals summarised in the KPMG survey. This is likely to be a function of both the size of the superannuation plans involved, the average account balances (in excess of $50,000) and the fact that there was a tender process in which a standard offering would not necessarily attract the business.

Table A.2: Recent master trust tender offers made to employers

	Case 1	**Case 2**	**Case 3**	**Case 4**	**Case 5**
Assets: $m	12	15	28	82	142
Membership (approx.)	160	308	754	1368	2001
Annual Expenses	117,000	146,000	311,000	730,000	1,217,000
% of assets	.98%	.98%	1.11%	.89%	.86%

A.3 Estimates prepared by Chant West Financial Services

Chant West Financial Services provided data on fund administration and investment costs that was published in the October 2001 issue of Super Review. It related to plans with an average account balance of $50,000, which is not an unusual level for well established corporate schemes. The data indicate total costs for a $10 million employer plan ranging from 1.06% to 1.47% for a growth multi-manager investment option. For a $50 million plan the range was from 0.85% to just over 1%. Investment costs tended to be between 0.5% and 1.0%, with administration costs below 0.5% in most instances.

For the three industry funds considered the total costs were around 0.5% of assets, with around 0.1% attributable to administration costs. These percentages are lower than estimates that are normally published given that they relate to an average account balance of $50,000 rather than the average $5,000 or $6,000 balance in most industry funds.

A.4 Estimates for individual master trust accounts prepared by Look Research

The Money Management Master Trust Research Report 2001 provides estimates of initial and ongoing fees for a wide range of superannuation master trusts marketed through financial planners to individuals. On-going fees for a $100,000 account balance varied widely, ranging from as low as 1% up to 2.6%. Most providers had fees in the range between 1.5% and 2% for accounts of this level.

A.5 Estimates for individual superannuation policy and low balance master trust accounts

Fees charged against smaller scale retail products tend to be around the 2.5% level. Of this up to 0.5% can be a trail commission paid to a financial adviser. If a superannuation product is sold direct, then there is no rebating of the trail commission to the purchaser.

Where the seller of the superannuation product provides both administration and investment services it is difficult to distinguish between administration and investment charges, and it is not unusual for the fee structure to simply have an aggregated asset management charges. Where external investment managers are offered the pricing structure becomes more sophisticated, although the end fees may not differ much in aggregate.

The pricing structure for superannuation products sold through master trust platforms tends to be along the lines of platform fees being between 1% and 1.5%, with investment fees depending on the manager used and level of investment. Typically such fees will be just below or just above 1%. Very small balances and/or more exotic investment mandates can attract higher charges.

Of the platform charge of between 1% and 1.5%, around 50 basis points appears to be actual costs of administration, with the remainder trail commissions and profit derivable from establishment of the brand and distribution service. Some dealer groups have established their own distribution platforms, or badged the platforms of others, so as to be able to take advantage of that gap between 0.5% and the net fees charged for use of the platform after trailing commissions are paid.

Appendix B: ASFA Comprehension testing of superannuation disclosure models

The research strategy was undertaken by the consultancy Ageing Agendas during the second half of 2000.

The brief for the consultancy required:

1. Providing consumer advice through a review of a Key Features Statement (KFS) developed by ASFA in consultation with the superannuation industry;
2. Undertaking diagnostic testing of the revised draft KFS with 24 consumers in face to ace interviews;
3. Revising the KFS in the light of the testing;
4. Testing a range of KFS documents with a new group of 24 consumers and providing advice on necessary reforms; and
5. Re-testing two KFS documents with the same formats but from different funds to test consumer's capacity to compare funds and providing advice on the implications.

The staged testing and revision of the KFS models resulted in considerable improvement in participant understanding and the development of a model which has proved to have been effective in communicating information to a sample of consumers with low levels of educational achievement.

The research revealed that neither ASFA's original KFS model nor the proposed CLERP 6 disclosure requirements wouldl produce adequate levels of comprehension of products, or allow informed comparison between products. Considerable consumer input is required to identify problems in understanding superannuation and developing remedial approaches. The key findings from the research are set out below.

Market segregation issues

Difficulties in understanding and using superannuation information occur at all level s of socio-economic and academic status.

Motivation is a better predictor of success that socio-economic status or education.
Consumers who have difficulty with content will use other props to help them get the message, regardless of whether those props (eg pictures on cover) are relevant or in fact misleading.

Left to themselves, consumers are more likely to select a product they feel they understand rather than a more complex one, irrespective of the merits of the products.

A proportion of consumers will always need verbal explanations of fund features and options to supplement written information. It is unlikely that these consumers would normally access financial planners. This makes information provided by fund staff an important element in the communication link. This information should be consistent with written material provided by the fund.

Format and layout

The format in which information is presented is extremely important in terms of both navigation and comprehension, and influences the consumer's attitude towards the information provided. This extends to type and size of font, clarity of colours used, organisation of material and its layout, the headings of tables.

When required to compare different products, format and presentation become even more important. Factors such as a common format and layout and consistency of terminology considerably enhance consumer understanding.

Use of Superannuation Jargon

Jargon and technical terminology should be avoided wherever possible.

Unavoidable technical information / terminology should be accompanied by clarifying statements in the text where they are used.

Consumers are assisted by glossary style explanations of general 'technical' or unfamiliar terminology about the fund. However, the glossary is not an effective substitute for consumer friendly explanations in the text.

Separation of technical information common to all funds (particularly tax information) assists in keeping the main text uncluttered and relatively jargon free. It also allows such technical information to be explained more effectively.

Issues of unitisation, fees and charges, and tax were the most troublesome for consumers.

Use of tables

Tables or similar illustrations need to be simple, and be presented within the relevant text, preferably on the same page or page spread.

Table headings need to clearly identify the purpose of the table, if it is to be used by consumers for a specific purpose (eg to compare fees, or returns).

Navigation aids

Headings that prompt consumer understanding appear to be very useful. An example of this is the use of questions, such as 'What is this Guide About?'

A clear and prominent table of contents reflecting those headings is essential to assist navigation, as are clear/ prominent page numbers.

In a two-column format, headings and subheadings should clearly show how the related text is set out. The use of colour bars across the page and subheadings to indicate sections of the text proved effective.

Comparison of fees

The use of percentages in fee information is a barrier to understanding, whether consumers are considering one fund only, or making comparisons. Dollar illustrations are an essential element in comprehension and assessment. Comparison information needs to be presented in very simplified formats.

Use of fund returns

Despite prominent warnings to the contrary, consumers will use historical fund returns to predict future returns where these are provided.

Conclusions

1. In a consumer choice environment, the disclosure model for superannuation products must ensure comparability of information as well as basic understanding of the material provided.
2. The results of the comprehension testing indicate that a high degree of regulatory prescription is likely be necessary to achieve the twin aims of comprehension and comparability.
3. The development of an effective disclosure model as the basis for such regulation must be performance based and user friendly , involving an intensive process of one on one testing for comprehension and comparability; and development of terminology and format drawn from such a testing process.
4. If across the board prescription based on the principles outlined above is not acceptable, such prescription should at least apply to all funds wishing to attract superannuation guarantee contributions under a choice of fund regime.
5. An extensive consumer education program is required around each of the main themes or issues covered in the disclosure document, such as fees and charges, investment choices and performance, availability of insurance, and how to compare such information from different funds.
6. Wherever possible, information provided by fund advisory or tele-services should use the same terminology as required in the standard disclosure document.

It is worth noting that 'Key Feature Statement' and 'Product Disclosure Statement' were not seen as helpful titles. Consumers generally found 'Guide to your XYZ Super(fund)' more helpful.

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