

▪ PHILLIPS FOX ▪

ACTUARIES & CONSULTANTS

Innovative solutions for complex problems

Superannuation Fees & Competition

Michael Rice
Director

Ian McEwin
University of NSW and LECG Ltd

FINAL REPORT
9 April 2002

Superannuation Competition And Fees

Executive Summary

1. Our Brief

Phillips Fox Actuaries & Consultants (PFAC) has been engaged by IFSA to undertake this project. The key work performed is:

Competition

In conjunction with Dr Ian McEwin, of the University of New South Wales and LECG Asia-Pacific, we have reviewed competition in the superannuation market place today. This includes an analysis of the retail market, including a review of those areas where it has been alleged that members are not receiving value for money.

We have examined the cost of financial advice. We note that this is almost always incorporated into the fees of retail products, rather than paid as a separate fee to the intermediary by members. We have also reviewed the extent of choice within the retail market.

Impact of Scale on Fees

We have analysed fees by size of fund. This shows that the price of delivery of services of Australian superannuation funds generally reduces with increasing fund size. Competition forces funds to reach the minimum efficient size. However, there are segments where this does not happen - and there are considerable cross-subsidies directed towards small accounts. As there are too many superannuation accounts, all members in those segments pay too much in fees. A failure to reach minimum efficient size and the presence of cross-subsidies suggest that most segments are not as competitive as they could be.

Segment Analysis

Part of our assignment has been to update Section B of PFAC's report *Choice of Superannuation Fund; Costs & Benefits to the Community* (November 1999). We have analysed the market as at June 2001, exactly two years after the previous results. We comment on the changes that have occurred in each market segment.

Examples

We have included several case studies to illustrate the relative impact of fees, taxes and investment performance. Specific cases are:

- A person with multiple accounts, who would pay excessive fees;
- A person who elects to go into a no-load low-cost fund but neglects to see a financial planner who can tell them about tax and investment strategies;
- The effect of taking a conservative investment strategy as opposed to a growth option;
- The effect of taking a high-cost fund that has a history of good performance.

Commentary on other documents

We have reviewed contemporary literature on the subject and, where appropriate, have made reference to the conclusions drawn by other parties.

2. Our credentials for this project

Our project team is headed by Michael Rice. Michael has extensive experience in the superannuation industry. His resume is set out in Appendix A. Paul Murphy, another senior actuary at PFAC, undertook most of the numerical work for this report.

Specific work we have undertaken related to this subject includes the following:

- PFAC compiled a report for IFSA in November 1999 reviewing fees for various segments of the superannuation industry.
- PFAC recently reviewed the Bateman Paper on fees that was commissioned by AIST.
- Michael Rice has been involved in the development of fee disclosure under FSR. In addition to client work in this area, he has assisted the Institute of Actuaries of Australia in its submissions, and he represented that body on Treasury's FSR Consultative Committee. He has also provided consulting advice to ASIC in this area.
- PFAC has assisted a number of organizations wishing to enter various segments of the superannuation market. This has included advice on segment size, likely growth, key purchasing criteria, the roles of various intermediaries and channel strategy. Fee and commission structures are an integral part of these assignments.
- PFAC is one of the few independent professional firms that conduct tenders for corporate funds wanting to outsource their employee superannuation arrangements. This gives us an insight into the fees incurred in corporate funds, employer-sponsored divisions of master trust and industry funds.

Dr Ian McEwin is an expert on competition policy. He is mentioned in the UK's *Global Competition Review as a leading expert on competition law and policy*. Ian's resume is also set out in Appendix A.

Ian has undertaken a significant number of assignments relating to competition issues. He has appeared as an expert witness in major litigation.

3. Summary & Conclusions

3.1 Competition within superannuation

We conclude that there is a high level of competition within the industry. This is reflected in a large number of products and suppliers within each segment. Strong competition between these groups generally ensures that members within regulatory constraints, receive good value. Competition coupled with an extensive media coverage of funds and fees provides incentives for suppliers to continually provide better value.

Improved value comes from enhanced services and better investment performance as well as lower management fees.

3.2 Segment Analysis

Fees vary between segments. The difference is largely due to:

- Economies of scale;
- Regulatory differences;
- Distribution costs where there is no monopoly (particularly for retail funds);
- Cost of advice; and
- Variations in member services, including a range of investment and insurance options.

Overall, fees, expressed as a percentage of assets, have reduced over the two year period. They now average 1.20% pa of assets, down from 1.24% in 1999 (on a comparable basis). This reduction has saved members \$200 million per annum.

A large number of corporate funds are now in wholesale arrangements within master trusts. This segment has a range of flexible services which are delivered at a low cost. Competition for this business has cut fees (and margins) considerably over the last two years.

During the period, the government introduced GST. This added about 2.5% to fees. It would appear that this cost has been absorbed in most segments.

3.3 Corporate Funds

Total expense rates have fallen since:

- Many smaller funds have converted to master trusts (or industry funds);
- Asset management fees have declined, mainly through competitive pressure on fund managers.

Many corporate funds now charge an explicit fee to members, so the rate of employer subsidisation has fallen significantly.

Average corporate fund expenses are slightly less than 1.0% of assets.

3.4 Industry Funds

Average fees have reduced from 1.5% to 1.18% of costs. For large funds (above \$1 billion), the fees average 1.15% of assets. This reflects higher average balances and lower investment fees paid to fund managers. The fees for small industry funds are about 1.3% p.a.

In our previous report, we noted the additional cost incurred by members for *interest rate smoothing*. We estimate this now to be less than 0.1% of assets.

Compared to other segments, member protection is a higher cost for industry funds, often exceeding 0.1% of assets.

3.5 Public Sector Funds

The public sector expense ratio has remained constant at 0.43%

3.6 Employer Sponsored Master Trusts

This segment contains the superannuation arrangements of many small businesses. This is part of the retail segment, which is largely serviced by commissioned advisers. However, most funds with assets exceeding about \$5 million are wholesale arrangements (even though they are often in the same product).

Overall, these employer-sponsored funds have lower average costs, largely due to the bigger corporate funds now transferring to them. Costs have reduced from 1.64% in 1999 to about 1.44% in 2001. The costs for those funds above \$5 million is on average about 1.16% of assets – equivalent to the large industry funds.

3.7 Retail Funds

Retail costs have been static over the period. Several factors have placed upward pressure on fees, including:

- The introduction of GST. This added about 2.5% to costs, which were less easy to absorb in the retail sector;
- Compliance costs, particularly those relating to licensing and competency of intermediaries;
- Increases in taxes for life insurance companies;
- The shift towards higher asset-based fees to compensate for the reduction in entry fees;
- The shift towards adviser-owned master trusts and wrap accounts, where dealer groups "dial-up" an asset fee for their own remuneration.

We estimate that retail fees at June 2001 averaged:

Employer Master Trust (less than \$5 million)	2.00%
Personal Superannuation	2.34%
Post Retirement	1.70%
RSAs	2.50%
ERFs	2.00%

3.8 DIY

The DIY funds are amongst the cheapest segments, due to the large average balances. The estimated average annual fee is slightly more than 1% of assets.

Those funds using advisers have higher fees but tend to be invested in high levels of growth assets. Funds run through accountants and which do not obtain investment advice tend to have higher levels of cash and fixed interest investments. Generally, the lower investment returns will cost more than the fees saved by not obtaining advice.

3.9 Future Trends

We expect that fees will reduce over the next few years arising from the high level of competition in the industry coupled with a number of likely developments:

- There are advances in electronic commerce which will cut administration costs for funds;
- Improved disclosure will encourage members to question fee levels;
- There will be a rationalisation of fund within several segments and this will provide surviving funds with higher membership and assets;
- There will be rationalisation of member accounts, leading to reduced member protection subsidies; and
- There will be further discounts in fund management discounts.

3.10 Other Points

- Disclosure within annual reports of corporate and industry funds has improved, but much work needs to be done to comply with FSR requirements. The disclosure of fees within the public material for most corporate and industry funds is inadequate, particularly concerning asset-based fees;
- Taxes are now \$6.4 billion p.a. which is slightly more than the fees for administration and investment combined;

Member balances reduce by 2.5% p.a. through fees and taxes. If inflation is 3%, the industry needs to earn about 5.5% to maintain values in real terms. Disturbingly, the trend is for higher tax revenue which more than offsets the impact of lower fees;

- The number of accounts per member continues to rise despite the efforts of many funds to encourage members to consolidate their accounts. In the last 2 years, accounts grew by about 5.5% p.a. while the labour force grew by about 1.2% pa;

Duplication of accounts increases the costs of member protection, which we estimate is about 5 basis points across the industry. Total wastage from duplicate fees is more than \$1 billion p.a;

- Compliance Costs are rising and this impacts directly on fee levels;
- There are been a shift in investments towards growth assets and this increases fees – but the extra performance far exceeds the additional costs;
- Members pay about \$1.2 billion a year in insurance premiums. The administration, distribution and profit margins within these contracts equates to 0.07% of assets of the superannuation industry. This is in addition to the average costs which apply to each segment of the industry.

Yours faithfully

Michael Rice
Ian McEwin

Table of Contents

Sections

1.	Competition	1
2.	Segment Analysis.....	3
2.1.	Superannuation Market Segments	3
2.2.	Employer Superannuation	4
2.3.	Method of calculating fees	5
2.4.	Charging Methods	5
2.5.	Corporate Funds	6
2.6.	Industry Funds	8
2.7.	Government Funds	10
2.8.	Self-Managed Funds	11
2.9.	Employer-sponsored master trusts.....	11
2.10.	Retail 1: Small employer funds in master trusts	13
2.11.	Retail 2: Personal Superannuation Fund Expenses	13
2.12.	Retail 3: Post Retirement Products	14
2.13.	Retail 4: Retirement Savings Accounts (RSA)	14
2.14.	Retail 5: Eligible Rollover Fund (ERF).....	15
2.15.	Summary of Current Expense Rates	15
2.16.	Fees by segment.....	16
2.17.	Fees by Function	18
2.18.	Profitability	18
2.19.	Fee Trends	19
3.	Analysis of Fees	20
3.1.	Disclosure	20
3.2.	Impact of Scale on Costs.....	20
3.3.	Cost of Advice	21
3.4.	Insurance Costs.....	22

3.5.	Impact of superannuation taxes	23
3.6.	Commentary on other documents	24
4.	Impact of fees and performance	26
4.1.	Examples	26
4.2.	Multiple Accounts.....	26
4.3.	Impact of growth assets.....	27
4.4.	Impact of low cost fund	28
4.5.	Impact of advice.....	28
Appendices		
A.	Resumes.....	29
A.1.	Michael Rice's Resume.....	29
A.2.	Ian McEwin's Resume	29
B.	Data Sources	31
B.1.	Corporate Funds	31
B.2.	Industry Funds	31
B.3.	Government Funds	32
C.	Planner Servicing Standards	33
C.1.	Purpose.....	33
C.2.	Minimum Standards.....	33

1. Competition

Superannuation is highly competitive in Australia. Investors, or their employers, have many investment and administration options. These vary by segment from the balanced portfolio of industry funds to choice of managers in master trusts through to individual shares and bonds in small self-managed funds.

Superannuation funds, by necessity, must compete to attract and keep investors. Funds compete in a number of dimensions. The main one is investment returns (net of costs) but also on the basis of investment philosophy, specialised expertise and the type of service offered.

Intense competition ensures that costs are minimised – a dollar saved due to lower costs is the same as an increased investment return of one dollar. In an informed market, companies that do not minimise costs soon lose market share.

Critics of the superannuation industry sometimes focus on costs such as expense ratios to indicate the level of competition. High expense ratios are assumed to mean a lack of competition. This is wrong. Costs, by themselves, do not say anything about the level of competition. Where products are differentiated, we expect to see differences in costs and product quality. Public policies aimed at simply minimising fund fees inevitably lead to lower quality product. Consumers will pay extra for new, innovative products. Forced to meet a regulated industry cost standard, funds will respond by cutting back on innovation.

However, competition ensures that costs (such as expense ratios) are driven down as far as possible for any given product or service. Competition forces firms to look for better ways of doing things over time. An indicator of effective competition is that costs trend downwards over time.

Competing firms selling identical products focus on reducing costs and marketing lower fees (and so higher returns) to consumers. Theoretically, consumers do not need to have detailed knowledge of comparative superannuation costs, only knowledge of comparative net returns. However, the past lack of uniform disclosure and transparency has created an environment with a focus on fee levels.

Competition, together with information about the characteristics of the product they are buying, maximises consumer welfare because they get what they want at the lowest possible cost. In competitive markets it is rational for consumers to be ignorant of a fund's costs. Competitors have a good knowledge of each other's costs – this is all that is needed for effective competition. Consumers need not know (this knowledge comes at a cost and provides little benefit).

A competitive car industry ensures that consumers obtain the types of cars they want at reasonable cost. To focus on the costs of gear-boxes as an indicator of competition in the car industry is misplaced. Most consumers would laugh at any suggestion that they need to know the cost of gear boxes when buying a car. Finding that consumers do not know the price of gear boxes does not provide a justification for compulsory consumer education to better assess gear-box prices. If any education is needed it should be targeted at the decisions consumers actually need to make in practice, ie aimed at improving consumer knowledge of the final product, not its components. Superannuation investors need to know fund performance (net of expenses) relative to risk, not the cost of any component.

So should consumers know the 'costs' of providing superannuation services? Consumers make decisions about superannuation based on likely returns – the amount they will end up

with upon retirement. If any education is required then it should be targeted at promoting awareness of products and their characteristics and helping superannuation investors to determine their own needs. Theoretically, consumers do not need to know what costs their superannuation funds incur. Competition between superannuation funds provides sufficient incentives to minimise costs.

Some consumer advocates focus on the effect that higher fees have on final superannuation assets. These comparisons do not mean anything, except to point out the importance of compound interest. Competition keeps costs as low as possible, given the products involved. Lack of competition means increased costs. Comparisons of fees and final superannuation asset amounts with different cost levels state the obvious – higher costs reduce final asset amounts. Better to focus on the mechanisms to reduce costs – fees reflect outcomes with different levels of competition.

Reflecting the complexity of the industry and the abundance of different products, we would expect to see a considerable variation in the fees charged. Differences in costs may arise from a number of sources – differences in the level of competition, differences in product characteristics (levels of risk, accessibility options) and also regulatory compliance costs.

Is there sufficient competition in the superannuation industry? This paper shows that there are many providers of superannuation services, the most important indicator of a competitive market. As well, barriers to entry are low, which means that if any excessive profits are being made or any niche not filled, there will be new entry (either by new firms or existing firms moving into new market segments). The industry works under an extensive regulatory structure to protect investors by setting prudential standards and mandating disclosure. Uniform disclosure under the *Financial Services Reform Act* will better allow consumers to evaluate products and their likely returns.

Inevitably, we must conclude that the level of competition in the superannuation industry is high, conducted by qualified professionals who, in the interests of being competitive, disclose to consumers the information that they need to make better decisions. The data in this report supports this conclusion. Costs are moving downwards as we would expect in a competitive industry as it matures and adapts to changing regulation.

2. Segment Analysis

2.1. Superannuation Market Segments

APRA segments the superannuation industry each quarter. The segmentation as at 30 June 2001 was as follows:

Industry Segments			
Industry Segments	Funds	Members millions	Assets \$ million
Corporate	3,235	1.570	81,352
Industry	139	6.977	45,276
Government	94	2.846	114,259
Self-managed	222,738	0.387	86,833
Sub-total	226,206	11.780	327,720
Retail	274	11.459	160,362
Balance			38,947
Sub-total	274	11.459	199,309
Total	226,480	23.239	527,029

The "balance" shown in the above table is made up of superannuation amounts included in life office statutory funds that APRA has not attributed to the fund types listed. In addition to the above, there is about \$100 billion in unfunded liabilities in respect of various public sector schemes.

The total number of members actually represents the number of different accounts held by all members. Many members have accounts in more than one fund.

Industry growth has been strong over the two year period since our last review, but has varied from segment to segment as shown in the following table:

Percentage Change in Assets. Two Years to 30/06/01	
Corporate	+19.4%
Industry	+52.0%
Government	+19.9%
Self-managed	+60.7%
Retail	+42.8%
Balance	-16.7%
Total	+29.7%

We have sub-divided the assets of the retail market and balance shown above into various segments using our own data-base of corporate superannuation master trusts and various reports produced by Rice Kachor Research.

Retail Market Segments		
Segment	Members (millions)	Assets \$ million
Employer Sponsored Master Trusts	2.775	38,843
Personal Superannuation	4.018	92,373
Post-Retirement Products	0.584	46,744
Retirement Savings Accounts	1.405	3,092
Eligible Rollover Funds	2.677	2,623
Balance		15,634
Total	11.459	199,309

Much of the employer sponsored segment has characteristics of the wholesale rather than retail markets.

2.2. Employer Superannuation

There are about 700,000 businesses making SG contributions in Australia. Most of these businesses have less than 50 employees. We estimate that there are about 750,000 arrangements for employer-sponsored business as some companies contribute to more than one fund.

Employers participate within retail master trusts or industry funds. Employers choose the fund for their employees. If there is a strong union influence or a strict mandate from an industrial award, an industry fund is used. If there is no restriction, the employer will usually select a master trust, often with the assistance of an adviser.

We have used various data to segment these businesses into the following components. As expected, the majority of businesses are small and have the following characteristics:

- They belong to a multi-employer fund;
- They have an accumulation benefit design;
- Members pay for their own insurance;
- Few employers subsidise the costs of the fund;
- They pay contributions at the SG rate only;
- They tend to use a default investment and insurance structure (in other words, they are not interested in setting benefit design); and
- The owner will either participate within the fund on a minimalist basis, or will establish a DIY fund.

In addition to the above, some small employers (proprietors) might also contribute to a self-managed fund.

Private Employers Segmented By Number of Employees						
	No. Of Employers	Very Small 1-4	Small 5-49	Medium 50-499	Large 500-2000	Jumbo >2000
Master Trusts	383,928	186,792	137,076	59,453	598	9
Corporate Funds	2,200	0	0	1,860	250	90
Industry Funds	363,872	205,000	151,000	7,662	200	10
TOTAL	750,000	391,792	288,076	68,975	1,048	109

We have used a figure of 2,200 funds above rather than the published figure of 3,235. Note that APRA corrected the number of corporate funds in its March 2001 return. The funds grew over the quarter from 2026 as at December 2000 to 3283 as at March 2001 (yet members and assets did not change materially). In the following nine months, the number of funds has only fallen by 48 despite the substantial number of wind-ups that are occurring.

We consider that there are a large number of corporate funds (without assets or members), possibly over 1,000, that are in the process of being wound-up and that these inflate APRA's corporate numbers. The recently released statistics for September 2001 appear to confirm this as the number of corporate funds for that quarter fell by 169.

2.3. Method of calculating fees

Each segment of the superannuation industry charges its members in different ways and the benefits and service levels vary between them.

In this section of this report, we:

- construct a more detailed picture of the segments;
- explain the fees charged to superannuation fund members within the various segments;
- combine the two previous items to calculate the total expenses charged by the superannuation industry; and
- make reasonable assumptions about the way segment data would alter as a result of choice and calculate the effect on expenses.

2.4. Charging Methods

While some employers, particularly those running defined benefit funds, subsidise the costs of managing superannuation, almost all funds now recover costs by charging a fee to members. This is the outcome we expect to see in a competitive market. Firms compete by offering their customers the sorts of products they want. Providing it is cost effective, competition forces firms to find new ways to obtain a competitive advantage. Once one firm moves to a fee-based cost regime, if that is what consumers want, other firms are forced to follow. An example of this occurred in the 1990's when retirement savings providers moves to unbundle their fees and charges.

Funds charge their members a variety of fees as shown in the following table. Some funds (such as retail master trusts) apply all of these charges, while others (such as industry funds) prefer to combine all charges into a simpler structure comprising just a member fee and an asset fee.

Type of cost	Method of charging
Administration costs	Dollar per member; Percent of assets and Percent of contributions (for smaller sub-funds)
Trustee costs	
Cost of compliance	
Asset costs	Percent of assets
	Difference between earning rate and rate credited (for Capital Guaranteed options)
Benefits	Fixed dollar amount per transaction
Loading on insurance	Percent of insurance premium; profit-sharing
Cost of distribution and advice	Percent of contributions;
	Percent of assets

In addition, several funds charge fees for the advice provided in establishing an account. These amounts vary from case to case.

In this report, we have converted complex charging scales back to simple scales for comparative purposes.

2.5. Corporate Funds

2.5.1. Nature of corporate funds

A Corporate Fund is an employer-sponsored superannuation fund managed under its own trust deed. It is sponsored by a single employer or several closely related employers.

The trustee must comprise equal numbers of employer and member representatives. The trustee, as with all superannuation funds, is responsible for all compliance; including audit, lodgement of statutory returns and communications with members

Corporate funds may have a defined benefit or defined contribution structure or maintain separate sections for each type of benefit. Increasingly funds are moving away from defined benefit. Typically they will close the defined benefit section to new members and encourage defined benefit members to transfer to the defined contribution section of the fund

To avoid the complex administrative and legal requirements of the current superannuation regime, there has been a marked tendency over the last few years for the smaller corporate funds to transfer to master trusts.

It used to be uncommon for corporate funds to make explicit charges against member accounts. This is still obviously the case for defined benefit membership. It is, however, becoming increasingly common to find explicit charges for defined contribution arrangements. Often these mimic industry fund charges of around \$1 p.w. but they can range considerably higher to \$100 per annum or more. Some funds make use of contribution charges – usually about 1%. In addition, some funds defray expenses by way of a deduction to the investment earnings credited to members' accounts.

The great majority of funds use outside investment managers to invest the assets of the fund. Due to competition, this leads to a fairly standard range of investment management charges which vary according to the complexity of the asset investment task. The charges range from less than 0.3% for cash funds up to 1.0% for international equity funds. As most portfolios attempt a balanced mix of investments, they average around 0.65%. Larger funds pay much lower asset management fees.

It is wrong to conclude that similar fees for similar products is the result of collusion. Highly competitive markets necessarily drive fees down to cost levels. If firms cannot reduce costs to that of the most efficient firm, they suffer a competitive disadvantage and lose customers. Collusion can only work in markets with small numbers of competitors – because firms can monitor each other's fees. As numbers increase this monitoring function becomes harder and lead to break-downs in collusion as the experience in many industries shows.

2.5.2. Market Data

The November 2001 issue of Super Review gave the assets and number of members of the 200 largest corporate superannuation funds. We have used this information, together with the APRA data, to divide the corporate superannuation funds into four segments – those with less than \$50 million of assets, those with \$50 million to \$250 million, those with \$250 million to \$1 billion and those with more than \$1 billion.

Market data was obtained by examining the charging structures of a sample of 25 corporate funds with combined assets of \$20.3 billion. The data was obtained from an examination of the 30 June 2001 annual reports of the funds, supplemented by other published material. The sample therefore amounts to 20% of corporate fund assets and 1% of corporate fund numbers. The sample included funds from all four size segments.

As with industry funds, the annual returns of the corporate superannuation funds do not include the separately disclosed cost of investment management and we have estimated these costs based on our experience.

2.5.3. Subsidisation

In our last report, we noted that the employer often subsidizes the fees of corporate funds. This occurs through direct payment of superannuation expenses (eg employed staff managing the fund) or through payment of the expenses. We estimated that this subsidisation was about 17% of the direct fees for this segment.

In our opinion, the level of this subsidisation is rapidly reducing, with employers opting to close defined benefit arrangements for new members and to charge accumulation members administration fees. We have not included any subsidisation costs in the expense rates.

2.5.4. Current Expense Charges

We expressed the expenses incurred by each of the sample funds as a percentage of assets. The asset percentages calculated from the sample data were in line with our expectations – that is, they are inversely proportional to fund size, indicating economies of scale (size). We increased these percentages by the cost of funds management expenses, which we took to be 0.60% for the funds of less than \$50 million scaling to 0.45% for the funds of more than \$1 billion. We then applied these expense rates to the total of the funds in each segment to determine the total expenses incurred by the corporate funds.

The results are given in the following table:

Corporate Funds Current Expense Charges					
Fund Size (\$m)	Funds	Members (millions)	Assets (\$m)	Expense Rate	Expenses (\$m)
<50	2,041	0.820	22,349	1.50%	335
50-250	112	0.262	11,785	1.00%	118
250-1,000	37	0.236	16,501	0.80%	132
>1,000	10	0.252	30,717	0.60%	184
Total	2,200	1.570	81,352	0.95%	769

The expenses of \$769 million represent 0.95% of assets. The relatively low fees are a function of high average member balances, economies of scale and absence of distribution expenses.

2.6. Industry Funds

2.6.1. Nature of Industry Funds

An Industry Fund is a non-profit, regulated superannuation fund providing full administration and communication services, and a limited number of insurance and investment options. Many of the larger industry funds have public-offer status.

Industry Funds have an umbrella trust deed and a trustee that is independent of members and employers. Board members of the trustee company are split between employee representatives and employer representatives, usually being appointed by trade unions and employer associations respectively.

Fees charged are usually expressed as a fixed amount per week – typically \$1.00. However, this is not sufficient to meet the costs of running these funds, so a margin is also taken out of investment earnings. Investment management costs are also deducted from fund earnings.

In recent years, many of the large industry funds have become public-offer. These funds now compete against each other for customers. Some funds are actively targeting larger employers; some have taken over smaller industry funds. This competitive activity is already leading to better benefits for members through wider choice of investments and better services.

Many industry funds have large numbers of “protected” members with balances less than \$1,000, for whom contributions have ceased or are received irregularly. The experience of industry funds has generally been that the investment earnings foregone on protected members’ account balances are not sufficient compensation for expenses incurred in maintaining these accounts. Consequently, a small reduction is made in the overall crediting rate to make allowance for the cost of managing these accounts.

The cost of member protection is estimated to be about 0.1% of assets for industry funds. Funds in other segments also incur this cost but have fewer members with balances below \$1,000.

2.6.2. Market Expense Data

APRA statistics show that there were 139 industry funds at 30 June 2001 with total assets of \$45 billion.

We have examined the 2001 annual reports of 12 large industry funds each with assets exceeding \$1 billion, and with total assets of \$37 billion (82% of the industry fund total). In total, the 12 funds report investment and administration expenses of \$251 million.

We have also examined the annual reports of 14 smaller industry funds with \$4.5 billion of assets (a further 10% of the industry total). They report expenses of \$37 million.

The 12 large funds and 14 smaller funds are listed in Appendix B. It should be noted that the remaining funds are generally small and many are currently being absorbed into large funds. For example, the ARF has taken over three small industry funds in the last six months.¹

After making suitable allowance for the funds with the remaining 8% of industry fund assets, we estimate that total reported expenses would be \$315 million. This is similar to APRA's estimate of these costs in its quarterly Superannuation Trends. The expenses (which do not include fees deducted from fund earnings) amount to 0.70% of assets.

2.6.3. Smoothing

In the past, many industry funds applied an adjustment to the rate earned by the fund before determining the "crediting rate". The purpose of the adjustment was to "smooth out" the investment performance by adding to or drawing down reserves. In our 1999 report, we calculated the cost of the smoothing reserve operated by industry funds.

Up to five years ago, funds were transferring up to 0.5% p.a. into reserves. The growth of membership meant that reserves continued to grow. However, this build up has stabilised, and even declined, for many funds. We examined the transfer to and from reserves for the major funds over the last three years and found that the net difference from actual earnings was less than 0.1% p.a. Accordingly, we do not consider that the holding of reserves *per se* can be termed to be an additional fee.

2.6.4. Investment Expenses

Industry funds do not separately report most of their investment fees paid to external funds managers in their accounts and, in most cases, no MER (management expense ratio) is disclosed. The fund managers' charges (and any asset-based administration expenses) are netted off the investment return.

As an example, one of the 12 large industry funds shows investment and administration expenses in its accounts that add to 0.88% of assets (this compares with the average for the 12 funds of 0.68%). However, when this fund disclosed expenses to us as part of a tender we were conducting for a client, they disclosed total expenses of 1.60% of assets. In other words, they disclosed a further 0.72% of expenses that are netted off the investment return.

Based on the information that we have gathered in work that we have done for other industry funds, we estimate typical fund management charges to be 0.45% for large funds and 0.60% for other funds.

2.6.5. Total industry fund expenses

The total estimated expenses of industry funds are given in the following table:

¹ Western Australian Legal Superannuation (\$17 million), Commercial Radio Industry Superannuation Fund (\$28 million) and EdSuper (\$12 million).

Total Industry Fund Expenses					
Fund Size (\$m)	Funds	Members (millions)	Assets (\$m)	Expense Rate	Expenses (\$m)
<1,000	127	1.256	8,150	1.30%	106
>1,000	12	5.721	37,126	1.15%	427
Total	139	6.977	45,276	1.18%	533

The average expense rate of 1.18% is a reduction from than our 1999 estimate of 1.50% of assets and is a result of;

- the growth in the average size of accounts per member; and
- the removal of an explicit charge for “smoothing”.

The fee, when expressed as a percentage of assets, appears higher than corporate funds or employer-sponsored master trusts. This reflects the low average member balances within industry funds.

2.7. Government Funds

2.7.1. Nature of Public Sector Funds

Public sector funds are funds operated by government funds and agencies for the benefit of their employees. There is a strong trend away from unfunded defined benefit plans to defined contribution plans, particularly for new employees.

2.7.2. Market Data

We examined the annual reports of a sample of 12 government funds. The sample funds had total assets of \$37,269 million, which is 33% of the assets of all government funds. The expenses of the sample funds were 0.43% of assets.

We obtained the market data for our 1999 report from an ASFA survey published in July 1998. This data also produced an expense rate of 0.43%

2.7.3. Current Expense Charges

The expenses disclosed include investment costs, so we have not had to adjust the expense rate of 0.43%. We estimate total expenses for the sector as \$491 million.

Funds	94
Members	2.846 million
Assets	\$114,259 million
Expenses	\$491 million

Government funds have a huge cost advantage over other segments. There are no distribution costs, few employer payroll points, economies of scale and high average member balances.

2.8. Self-Managed Funds

2.8.1. Nature of Self-Managed Funds

"Do It Yourself" Funds are officially known as Self-Managed Superannuation Funds. Each member must be a trustee or a director of the trustee. Funds may have no more than four members and the typical fund has two. Self-Managed Funds are regulated by the ATO, rather than by APRA.

2.8.2. Market Data

The operators of self-managed funds usually have services provided by an accountant or by an investment adviser.

Where an accountant is the sole services provider, fees are typically around \$1,500 per year. The investment strategy is often heavily oriented into defensive investments, even cash. The cost of running these funds is low since average balances are high and the members often select the investment strategy themselves.

Where services are supplied through an investment adviser, the same service fee of around \$1,500 will apply but there will also be advice on retirement planning, investment strategy and technical matters. Further, a higher portion of investments will be steered into managed funds. Together, this will typically add 1% of assets to total fees.

The investment strategy is more oriented towards equities and managed funds and is likely to produce much better results than cash or fixed interest over the lifetime of the member. The advice may also lead to better structures with reduced taxes and higher social security benefits.

No data of the relative market shares of the different types of service provider is currently available, though we are in the process of gathering this data through a separate project. Based on the views of various suppliers of services to self managed funds, we have assumed that advisers have a two-thirds market share and that fees are \$1,500 per fund plus 0.67% of assets. The fee of \$1,500 is 0.38% of the average self-managed fund of \$390,000. The total estimated average fee is therefore 1.05% of assets.

Funds	222,738
Members	0.387 million
Assets	\$86,833 million
Expenses	\$912 million

2.9. Employer-sponsored master trusts

2.9.1. Nature of master trusts

A Master Trust is a public-offer, regulated superannuation fund providing full administration and communication services, and a number of insurance and investment options.

It has the facility to accept contributions from any employer and cater for the needs of a typical employer-sponsored plan. The funds have an umbrella trust deed and a trustee that is independent of members and employers.

These entities are commercial and exist to make profits out of superannuation management. The products often include facilities for personal superannuation business, non-super investments and post-retirement products.

Competition in the market is strongest in this segment. It is not surprising that the level of member services in this segment is more comprehensive than in any other segment.

2.9.2. Market Data

Employer master trust superannuation can be divided into two main segments. Where the assets are less than \$5 million, the services of an investment adviser are generally used (or the employer may deal directly with the master trust, particularly if the product is owned by a bank). The fee scale published in the prospectus of the master trust will generally apply. If the services of an adviser are used, the adviser is rewarded on a commission basis (and possibly also with service fees). Clearly, these are retail products.

Where the assets exceed \$5 million, the employer generally uses the services of a professional adviser to select the master trust. The trust is selected after a tender and the fee scale is substantially less than the prospectus scale. The professional adviser is rewarded by a fee for actual service rather than by a commission based on the value of business. This is not an economic option for smaller funds as the cost of employing a fee-based consultant would be prohibitive. Further, the commission is paid by members, whereas a consulting fee would normally be paid by the employer.

Clearly, these products are wholesale for business over \$5 million, though they are lumped into retail by APRA because they are often part of the same economic entity as retail business.

We have determined the market fees in the over \$5 million segment by reference to the fees charged by the winners of fifteen recent master trust tenders conducted by our firm. In each case, several companies tendered, so we can estimate costs accurately from a relatively small sample.

The fees of the winning company are not always the lowest tendered – service standards, educational facilities and investment strategies are also considered by the employer.

We have calculated the fee rates separately for three sub-segments.

We have determined the fees for the under \$5 million segment by reference to the prospectuses of the leading master trusts.

2.9.3. Current Expense Charges

The results of our calculations are shown in the following table. We have not had to add any fund management charges to the calculated rates – they are explicitly disclosed.

The distribution of assets between the plan size segments is based on our market knowledge and a survey of master trusts. The total amount of the assets for the sector has been taken from APRA statistics.

Employer sponsored Master Trusts Current Expense Charges			
Plan Size (\$m)	Total Assets (\$m)	Expense rate	Expenses (\$m)
<5	12,818	2.00%	256
5-10	11,653	1.30%	151
10-50	11,653	1.10%	128
>50	2,719	0.85%	23
Total	38,843	1.44%	558

The expenses of \$558 million represent 1.44% of assets. However, the average fee after excluding smaller funds (those less than \$5 million) is 1.16% of assets. The expense rate of 1.1% for employer plans in the \$10 million to \$50 million segment is less than the rate of 1.5% for corporate plans of less than \$50 million. This is consistent with our experience of the savings realised when corporate plans of this size convert to master trust. Above \$50 million, the cost of corporate plans and master trusts is similar.

2.10. Retail 1: Small employer funds in master trusts

The small funds shown above have an average expense rate of about 2% of assets. This reflects the retail nature of this business.

2.11. Retail 2: Personal Superannuation Fund Expenses

2.11.1. Nature of Personal Super Funds

Personal Superannuation covers a range of individual, retail, regulated products. They provide full administration and communication services, and a number of insurance and investment options.

They accept contributions (single or regular) from a single person. The major participants are the self-employed and people with preserved benefits.

2.11.2. Market Data

There are a wide group of policies ranging from whole-of-life contracts through to savings plans and managed funds. The cost structures vary considerably. Based on a survey of the personal superannuation market², we estimate that the average charge paid by members of personal superannuation funds equates to \$78 plus 2% of assets.

2.11.3. Current Expense Charges

Based on the previous section and our sub-division of the APRA data, we estimate that personal superannuation fund members are being charged \$2,161 million per year. This is 2.34% of assets.

Members	4.018 million
---------	---------------

² Dexas (previously Rice Kachor Research)

Assets	\$92,373 million
Charges	\$2,161 million

Retail expenses have been static over the last two years and have even risen slightly in some areas. Part of the reason for this was the introduction of GST which had an effect of about 2.5% on fees. Another area has been the growth of master trusts and wrap accounts where dealer groups have taken a larger share of fees within their own businesses. There has also been a shift from entry fees (based on contributions) to higher asset fees.

2.12. Retail 3: Post Retirement Products

2.12.1. Nature of Retirement Income Products

Retirement Products cover a range of individual, retail, regulated products. They provide full administration and communication services, and a number of insurance and investment options.

They do not accept contributions, being designed to convert a lump sum amount into a regular income stream. Products include lifetime and term certain annuities and allocated pensions.

2.12.2. Market Data

Allocated pensions account for 80% of the assets of the segment and immediate annuities for the other 20%. Charges for allocated pensions are similar to charges for personal superannuation but the average balances are higher and we estimate that the average charge equates to \$78 plus 1.75% of assets. Immediate annuities do not have an explicit charge but we estimate the implicit charge as \$78 plus 1% of assets. The weighted average charge for allocated pensions and annuities is therefore \$78 plus 1.6% of assets.

2.12.3. Current Expense Charges

Based on the previous section and our sub-division of the APRA data, we estimate that retirement income investors are currently being charged \$793 million per year. This is 1.70% of assets.

Members	0.584 million
Assets	\$46,744 million
Charges	\$793 million

2.13. Retail 4: Retirement Savings Accounts (RSA)

2.13.1. Nature of RSA's

Retirement Savings Accounts are capital guaranteed superannuation accounts operated by financial institutions without any trust arrangement. Contributions to these products can be made by employers or members. These products are run like simple bank accounts and they do not include any superannuation services or advice.

2.13.2. Market Data

Seven institutions offer RSA's. There are also RSA "look-alikes" offered as an investment-option in some master trusts. Account fees vary based on whether an explicit fee or an interest rate spread is used.

Where an interest rate spread is used, it is necessary to treat this as the implicit fee on the product. If this is not done, the fee will appear to be negligible. We estimate that the average implicit fee is 2.5%.

2.13.3. Current Expense Charges

Based on the previous section and our sub-division of the APRA data, we estimate that RSA account holders are currently being charged \$77 million per year.

Members	1.405 million
Assets	\$3,092 million
Charges	\$77 million

2.14. Retail 5: Eligible Rollover Fund (ERF)

2.14.1. Nature of ERFs

When a member leaves a fund and gives no direction as to how their account is to be dealt with, the trustee of the fund may transfer the account to an Eligible Rollover Fund. ERFs consist of many small accounts with a conservative investment style and low account keeping fees.

2.14.2. Market Data

We have taken into account an old APRA Bulletin (December 1998) and a current DEXX&R report to estimate the size of the ERF market. We have estimated the implicit charge to be 2%.

2.14.3. Current Expense Charges

We estimate that ERF members are paying expenses of \$52 million.

Members	2.677 million
Assets	\$2.623 million
Charges	\$52 million

2.15. Summary of Current Expense Rates

The current charging scale of the various segments of the superannuation industry can be simplified to the following expense rates expressed as a percentage of assets.

Superannuation Segments Current Expense Rates			
Sector	Segment	Employer Fund Size (\$ million)	Expense Rate %
Self Managed	Self Managed (DIY)		1.05
Wholesale	Corporate	<50	1.50
		50-250	1.00
		250-1,000	0.80
		>1,000	0.60
	Employer Master Trust	5-10	1.30
		10-50	1.10
		>50	0.85
	Industry	<1,000	1.30
>1,000		1.15	
Government		0.43	
Retail	Employer Master Trust	<5	2.00
	Personal Superannuation		2.34
	Post Retirement		1.70
	RSAs		2.50
	ERFs		2.00

Clearly, there are considerable savings in expenses arising from size. Competition forces firms to seek minimum efficient size over time.

2.16. Fees by segment

We can now produce a broad segmentation of fees for all segments.

Fees By Superannuation Segment				
Sector	Segment	Members million	Assets \$ million	Expenses \$ million
Wholesale	Corporate	1.570	81,352	769
	Industry	6.977	45,276	533
	Government	2.846	114,259	491
Self-managed	Self-managed	0.387	86,833	912
Retail	Employer Master Trust ³	2.775	38,843	558
	Personal Superannuation	4.018	92,373	2,161
	Post Retirement	0.584	46,744	793
	RSAs	1.405	3,092	77
	ERFs	2.677	2,623	52
Balance of assets			15,634	0
Total		23.238	527,029	6,346

³ Includes larger corporate funds (above \$5 million) which are wholesale

The fees amount to 1.20% of assets. We have adjusted our 1999 analysis to include interest margins on products such as RSA's and ERF's. The comparable result is 1.24% of the assets at that time. Therefore, fees have reduced marginally over the period.

Had fees remained at 1.24% of assets, members would be paying an additional \$200m a year.

Expense Rates by Function

We have apportioned the expense rates in section 2.15 according to the three main functions performed by superannuation funds – investment, administration and service and distribution. The distribution costs include advertising and commission.

The distribution costs for corporate and government funds have been shown as nil because they do not recruit members from the public. Large industry funds have some advertising costs and are beginning to build distribution costs. Most of the retail sector has significant distribution costs.

The apportionment is based on:

- The information given in the preceding sections of this report;
- The split between investment and administration costs given in the government sector reports in the sample described earlier; and
- The apportionment given in the June 2001 edition of the Financial Services Digest published by Deutsche Bank⁴.

Superannuation Segments Expense Rates By Function						
Sector	Segment	Employer Fund Size \$ million	Invest -ment %	Admin %	Distrib -ution %	Total Expense Rate %
Self Managed	Self Managed		0.34	0.38	0.33	1.05
Wholesale	Corporate	<50	0.60	0.90	0.00	1.50
		50-250	0.55	0.45	0.00	1.00
		250-1,000	0.50	0.30	0.00	0.80
		>1,000	0.45	0.15	0.00	0.60
	Employer Master Trust	5-10	0.55	0.55	0.20	1.30
		10-50	0.50	0.50	0.10	1.10
		>50	0.40	0.35	0.10	0.85
	Industry	<1,000	0.60	0.60	0.10	1.30
		>1,000	0.45	0.60	0.10	1.15
Government			0.20	0.23	0.00	0.43
Retail	Employer Master Trust	<5	0.60	0.90	0.50	2.00
	Personal Super		1.24	0.60	0.50	2.34
	Post Retirement		0.60	0.60	0.50	1.70
	RSAs		1.40	0.60	0.50	2.50
	ERFs		1.40	0.60	0.00	2.00

⁴ Financial Services Digest June 2001 prepared by Financial Services Team, Australia Financial Services

The difference in fee levels between these segments is a function of:

- The asset classes utilized;
- Average account size per member;
- Average size funds within a segment;
- Levels of service provided;
- Distribution costs; and
- Cost of advice (where provided).

2.17. Fees by Function

We have used the table in the previous section to apportion the total estimated superannuation expense of \$6.346 billion by function. The results are shown in the following table:

Superannuation Fees By Function					
Sector	Segment	Investment (\$ million)	Admin- istration (\$ million)	Distrib- ution (\$ million)	Total Expenses (\$ million)
Wholesale	Corporate	420	349	-	769
	Industry	216	272	45	533
	Government	228	263	-	491
Self-managed	Self-managed	295	330	287	912
Retail	Employer Master Trust	210	246	102	558
	Personal Superannuation	1,145	554	462	2,161
	Post Retirement	280	280	233	793
	RSAs	43	19	15	77
	ERFs	36	16	-	52
Sub-total		2,873	2,329	1,144	6,346
Insurance costs ⁵		-	247	109	356
Total		2,873	2,576	1,253	6,702

2.18. Profitability

There is a perception that rising assets under management have led to increased profitability of the fund management industry. In fact, competition has led to falling fees in several areas including fund management and administration.

Australia has high levels of competition but many participants lack the scale to be profitable. We can expect that there will be continuing rationalisation over time as many will not be prepared to invest further capital into such a competitive market. They will be forced to merge to achieve the economies of scale necessary to be cost-effective.

⁵ Insurance costs are calculated in section 3.4

Already, the significant compliance and distribution costs mean that the break-even for an employer-sponsored master trust is well over \$1 billion.

Profitability is not disclosed by segment so it is not easy to ascertain current levels. It is noticeable, however, that the P/E ratios of the ASX-listed specialist superannuation entities are not excessively high. If superannuation (which has a guaranteed cash flow exceeding \$30 billion a year) were a goldmine, the sharemarket prices of superannuation companies would surely reflect this.

2.19. Fee Trends

We expect that fees will reduce over the next few years arising from the high level of competition in the industry coupled with a number of likely developments:

- There are advances in electronic commerce which will cut administration costs for funds;
- Improved disclosure will encourage members to question fee levels;
- There will be a rationalisation of funds within several segments and this will provide surviving funds with higher membership and assets;
- There will be rationalisation of member accounts, leading to reduced member protection subsidies; and
- There will be further discounts in fund management expenses.

We also expect that there will be pressure on distribution costs and expect these to fall as a percentage of assets.

3. Analysis of Fees

3.1. Disclosure

Our review of the annual reports of superannuation funds confirms that it is extremely difficult for any member to understand the fees charged to them. The range and quality of services varies significantly amongst the funds and it would not be easy for a member to evaluate these differences. However, consumers do not need to fully understand fees – they can be ‘rationally’ ignorant and the market will still function effectively. With competition, firms are forced to minimise costs and it is this competition that forces firms to be internally efficient and to disclose the type and amount of information consumers actually want and are prepared to pay for.

Different segments will have different costs depending on differences in services provided as well as differences in regulatory regimes. As long as firms monitor each other (which they must do in a competitive environment) any advantage gained by one firm in lowering costs will soon be matched by others. There is clear evidence of this happening in the Australian superannuation market.

The level of disclosure is much better in the Public Offer funds due to the current legislative requirements. The shift to uniform disclosure under the Financial Services Reform Act will significantly improve the level of disclosure for members. We expect that comparisons between funds will become easier, though it will still be difficult for members to work out if one fund is more efficient than another due to the complexity of superannuation and the difficulty of evaluating some services. Clearly there will be an ongoing need for advice in this marketplace.

The main area where the information on funds is deficient at present is the display of asset-based fees as a deduction from the fund earning rate rather than an explicit fee shown on member statements. The new legislation largely overcomes this by the universal application of ongoing management charges (OMC) for a \$10,000 investment. The OMC will give a crude interfund comparison and although a simple statistic can be misleading in some cases, it will certainly be a significant advance on the current level of disclosure.

3.2. Impact of Scale on Costs

3.2.1. Corporate Funds

The results in the previous section of this Report show that the fees charged to members reduce considerably with size of plan in some industry segments. The very large corporate funds and those large corporations that have outsourced to Master Trusts pay significantly less than average. There are several reasons for this including:

- Most large employers transfer data and funds electronically and this significantly cuts the costs of transactions.
- The large fund market is extremely competitive and this places pressure on margins.
- The average balances of the corporate market means that the fees charged are a smaller percentage of assets though they are often larger per member in dollar terms.

The size of members account is an important factor as can be seen from the DIY market and the post-retirement market where the average balance is significantly higher than other

superannuation segments. These segments also require less compliance and the turnover of members is smaller.

3.2.2. Cross subsidies

The simple charging structure adopted by industry funds means that employees of large businesses subsidise employees of small businesses. An example is REST, the retail industry fund. A large number of active members are employed by a small number of large retailers (eg Coles Myer and Woolworths). These employers supply computer data of contributions for their employees, giving REST a substantial flow of cheaply administered contributions. This subsidises the cost of administering contributions received from small shopkeepers with one or two casual staff. The REST costs per member would be higher for employees of small business without the cross subsidy.

By contrast, public-offer funds operated for profit do not have the same level of cross-subsidies. The different attitude to cross subsidies is reflected in the volume discounts offered to large sub-funds.

While not discussing the merits of cross-subsidies to small business, the fact that cross-subsidies can exist suggests a lack of competition in the industry funds segment. That public offer funds do not have the same level of cross subsidies suggests more competition (and so explains the lower costs that can be obtained by larger employers).

Now that the larger industry funds have become public offer, they are beginning to market to larger companies (including clients of other industry funds). In a competitive environment, they will be forced to reduce their cross-subsidies to compete.

3.3. Cost of Advice

In the previous section, we estimated that total distribution costs incurred by superannuation funds are about \$1.25 Billion or slightly less than 20% of all fees paid by members. A large proportion of these costs represent commissions paid to financial advisers.

Some commentators consider that commission should not be allowed on compulsory employer (SG) contributions. This view is based on a perception that commission is paid for procuring business rather than for providing professional advice.

Commission is an emotive topic and it is useful to list the key issues:

- What do advisers do to earn their commission? What value do they add?
- Commission payments are made by the fund. Members may find it difficult to evaluate the cost of the advice that they receive.
- Over the last decade, there has been a shift from commission based on contributions to commission based on assets. This spreads the commission over time but also increases the total payments.
- Advisers can often vary their commission rate through “dial-ups”. As the maximum rate is disclosed in published material, rather than the average rate, it can be difficult for a member to assess what is fair and reasonable.

- Advice is provided to the employer, the members and (in some cases) to the trustee. Members may not be aware of all the work done by an adviser.

Generally, members receiving advice are more likely to move away from defensive assets into growth assets. The extra return will out-weigh the cost of the advice, so the member will be better off. It is true that some advisers may charge more than others for the same advice. However, the cost of advice is set by the market. Those seeking advice should shop-around.

We are not aware of any research that indicates whether members receive good value or not for the advice they receive. We expect that improved disclosure under FSR will improve member's awareness of the price they pay. If the market levels are too high, they will adjust as members shop around (in so far as they are allowed to do this).

It is interesting that those people on high balances rarely move to industry funds even though they would be able to access growth assets at a moderate fee. Presumably, these people do place a value on the advice they receive. If they did not, they would simply move to the funds with the lowest fee structures.

Within financial services, there has been a major shift from payment of up-front commissions for procurement of business towards regular ongoing commission earnings paid for servicing clients. This means that fees are now more closely related to actual services provided which is a natural consequence of a maturing industry.

Appendix C shows the service requirements set for advisers by one major institution offering employer-sponsored superannuation services. AMP is a market leader and will only pay trail commissions if these standards are met.

3.4. Insurance Costs

Almost all members of superannuation funds have insurance cover. About \$750 million of annual premiums are paid through employer-superannuation arrangements, and a further \$450 million of premiums are paid through personal superannuation arrangements.

The administration costs (and profit margins) of managing the insurance arrangements and the commissions paid to advisers are built into these premiums. We estimate that these are:

Insurance Costs				
Superannuation	Premiums (\$M)	Admin costs & profit margin	Commission	All costs
Employer	750	112	19	131
Personal	450	135	90	225
TOTAL	1,200	247	109	356

Alternately, it could be argued that there is a further \$356 million of fees built into premium rates of insurance arrangements. This is about 0.07% of all superannuation assets.

3.5. Impact of superannuation taxes

3.5.1. Tax levels

Last year, the Federal Government collected over \$6.4 billion p.a. from superannuation taxes. This does not offset the tax deductions made on contributions and it is at one-third of the level of income benefits paid to Age Pensioners. Hence, the government argues that superannuation receives substantial tax concessions each year.

However, we have a structure where government policy is, over the long-term, designed to wean the population off the Age Pension through encouragement of private superannuation. Therefore, it appears contradictory to encourage people to save through superannuation whilst simultaneously taxing the benefits before they are received. However, any tax reduction will need to be linked to integration of superannuation and social security payments in retirement.

Ross Clare of ASFA has estimated the total taxes paid by all superannuation funds for the last six years. We have expressed his estimates as a percentage of total assets of superannuation at the mid-year of each period⁶:

Total Taxes Paid by all Superannuation Funds					
Year	Tax from Super Funds (\$m)	Tax from Life Companies (\$m)	Total (\$m)	Super Assets (\$m)	Tax as % of assets
1995-96	1,634	410	2,044	246,343	0.83
1996-97	2,595	650	3,245	283,515	1.14
1997-98	3,093	775	3,868	339,453	1.14
1998-99	3,916	980	4,964	372,619	1.33
1999-00	3,893	975	4,868	451,743	1.08
2000-01	5,087 (actual)	1,290	6,377	504,025	1.27

It is interesting to note that the total taxes now exceed the fees charged within the industry. These amounts do not include taxes paid by retirees on their benefits or by members taking lump sum benefits. Further, it does not include the costs of collecting the taxes.

Member balances reduce by 2.5% p.a. through fees and taxes. If inflation is 3%, the industry needs to earn about 5.5% to maintain values in real terms.

3.5.2. Tax trends

The disturbing trend is that taxes are trending upwards as a percentage of assets whereas fees are reducing.

Tax amounts within superannuation could keep rising indefinitely as it is linked to cash flow (contributions) and fund growth (taxes on investment earnings).

The expected tax for 2001/02 is calculated as follows:

Expected Deductible Contributions (EDC) = \$29,000 million.	
Tax on EDC	4,350

⁶ Source: 2000-2001 Budget Papers and ASFA Research Centre estimates and APRA Superannuation Trends

Investment income (say, 6% net of \$550,000 m) = 33,000 million	
Tax on income (say, at 12% after allowing for imputation credits)	3,960
Surcharge	750
Deductions (admin expenses and premiums) 0.15*(2,576+1,253+1,200) =	(750)

Expected tax is \$8.3 billion, though there will be a lag for collection.

Therefore, it is likely that any benefits to investors from lower fees over the next few years will be more than offset by the growth in superannuation taxes.

In three years time, it is not inconceivable that we will get:

Fees reducing from 1.20% to 1.1% of assets (member balances)
Taxes increasing from 1.27% to 1.5%
All deductions from fees and taxes increasing from 2.47% to 2.6%

We think that it is sufficient to say that taxes are rising faster than fee levels and that this should be a focus of policy makers.

3.6. Commentary on other documents

3.6.1. ASFA research centre

In November 2001, Ross Clare produced a document “Are administration and investment costs in the Australian Superannuation Industry too high?”. Ross has analysed superannuation fees within Australia and made some international comparisons. Although he uses different assumptions to those used in this report, his general conclusion is that the average cost of administration and investment charges in superannuation funds is 1.3% of assets, which is similar to our conclusion.

Ross also draws comparison between the fees paid by members with the taxes imposed on funds, thereby reducing member balances.

His research is useful in pointing out the problems with most published fee comparisons whether by media or researchers. His research establishes that contrary to popular assertions, costs in Australia are trending towards 1% of account balances. Ironically, it was this type of “popularism” that led to the cap on UK stakeholder pensions of 1% on the combined administration and investment fees. Given that the UK system is a voluntary one, it is difficult to see how any institution could provide a service at that level and pay the necessary distribution costs.

3.6.2. AIST paper

We have considered the paper produced by Hazel Bateman for AIST on fees. Her analysis relates fee levels to the size of projected member balances. She expresses fees as the amount of retirement benefit lost.

Our paper and comments made by ASFA in the above paper, both point out flaws in this analysis.

The key difficulties are as follows:

- It is an oversimplification to take a "snapshot" of current charges and then extrapolate them over the working lifetime of individuals. This presupposes that the individual will not reassess the appropriate vehicle for their superannuation as their account balance increases;
- Costs within a fund are not necessarily static. Many funds have sliding scales so that today's simplistic asset fee will reduce in time as the member account grows.
- We can expect the level of fees and charges within the Australian superannuation system to change, and decline, as the system matures. Put simply, as total assets under management increase and average account balances increase, we will see expenses decline as a percentage of assets.
- The inclusion of all fees in the Bateman paper (including the allocation for financial advice) means that comparisons are not made on a consistent basis (some funds do not provide personal advice). That is not to say that members should not be able to evaluate the worth of the advice given to them.

Different fee levels are likely to be associated with different returns. So the different NET balances need to be compared, not simply the net balance as returns are kept constant but fees are changed. Investment fees need to be included, yet the simple metric does not allow for the cost of higher risk investments, with higher returns. In particular, over the last few years, the proportion of international assets has grown substantially. This will have increased fees - but the impact on future retirement benefits should be an *increase* rather than a reduction due to the extra investment returns expected.

4. Impact of fees and performance

4.1. Examples

We have included several examples to illustrate the relative effect of fees and investment performance. Specific examples are:

- A person with multiple accounts, who would pay excessive fees;
- The effect of taking a conservative investment strategy as opposed to a growth option;
- A person who elects to go into a no-load low-cost fund but neglects to see a financial planner who can tell them about tax and investment strategies;
- The effect of taking a high-cost fund that has a history of good performance.

4.2. Multiple Accounts

4.2.1. Number of accounts

The overall number of member accounts (23.2 million at June 2001) far exceeds the adult population because many people belong to more than one fund. We can compare the number of accounts with the number of employees covered by superannuation. At June 2001, 88% of the adult population was covered by superannuation.

Date	Average accounts
2001	3.0
1998	2.7
1996	2.5

The number of accounts continues to rise despite the efforts of many funds for consolidation. In the last 2 years, accounts grew by about 5.5% p.a. while the labour force grew by about 1.2% p.a. Duplication of accounts increases the costs of member protection, which we estimate is about 5 basis points across the industry.

4.2.2. Impact of multiple accounts

Many members leave their account balance behind on termination of service. If the balance is large, it is usually rolled-over into a new fund. If it is small, members often do not consolidate it.

The cost of maintaining a separate small fund with no regular contributions averages \$50 plus 1.0% of assets (investment charges would still be paid on consolidation). Therefore, a balance of \$5,000 will cost \$100 a year to maintain. In fact, the average account balance is probably closer to \$2,000, so the additional fees are about \$70 per account. As these accounts tend to be unprofitable, their elimination would not lead to higher fees on the remaining accounts.

As many duplicate accounts are subject to member protection and do not incur fees, some savings through rationalisation would be reflected in the elimination of cross-subsidies rather than actual fees saved. Theoretically, the shift to one account per person could save \$1,080 million in fees - or 17% of all fees. While it is not practical to rationalise all business, it would appear realistic to eliminate 50% of the surplus accounts and save more than \$500 million p.a.

4.3. Impact of growth assets

4.3.3. Returns versus Fees

Investment management costs for growth assets tend to be around 50 basis points higher than the equivalent costs for investment in cash or capital guaranteed funds. Whilst there is an increased cost to investing in growth assets, the long term benefits of investment in growth assets far outweighs the increased cost.

For example, assuming an inflation rate of 2% and that capital guaranteed assets will earn 4% and growth assets will earn 7% in the future, a 25 year old would accumulate around 4.3 times salary at age 65 using conservative investment of his SG contributions and around 7.3 times salary investing in growth assets. This occurs despite our assumption that cash style investments cost around 0.4% of assets while growth assets may cost around 1.0% of assets.

The results are not as marked for someone older. For example, for a 40 year old the conservative investment will result in around 2.4 times salary as opposed to around 3.2 times salary for the growth approach.

It should be noted that actual investment costs vary widely depending on the type of fund and that some funds obviously supplement their other management fees by deducting a percentage of assets. However, we believe that the conclusions stand for the great majority of arrangements.

4.3.4. Shift to growth assets

There has been a shift towards growth assets over the last decade. This has been beneficial for most members. The following table shows the high average portion now held by most funds. The portions are taken from APRA supplemented by our own research.

Growth Assets by segment			
Sector	Segment	Percent Growth assets	Expense Rates
Wholesale	Corporate	75%	0.95
	Industry	73%	1.18
	Government	74%	0.43
	Employer master trust	70%	2.00
Self-managed	Self-managed	73%	1.05
Retail	Employer Master Trust	70%	1.16
	Personal Superannuation	79%	2.34
	Post Retirement	66%	1.70
	RSAs	Nil	2.50
	ERFs	Nil	2.00
Total		72%	1.20%

The post-retirement portion is low due to the asset mix backing annuity products.

4.4. Impact of low cost fund

If a person were to use low fees as the sole factor in selecting a fund, they would probably opt for a Retirement Savings Account (which discloses a negligible explicit fee). In fact, the fee they would pay is reflected in the interest margin on the product. It is conceivable that a growth fund will out-perform an RSA by 4% p.a. or more. Even a retail balanced fund should give a net return of 1.5% p.a. above an RSA.

Similarly, a capital guaranteed or secure fund is likely to under-perform a growth fund by between 1.0 and 1.5% p.a. Therefore, it is desirable that members are steered into funds with high allocations to growth assets.

4.5. Impact of advice

There is a high correlation between obtaining advice and investing in growth assets. This can be seen most clearly in the personal superannuation market. This is a retail segment with high fees, but it also has the highest portion of growth assets of any segment.

A. Resumes

A.1. Michael Rice's Resume

Michael has extensive experience in the financial services industry both in Australia and overseas. He specialises in providing strategic advice to financial institutions, government agencies and large superannuation funds. Michael founded the firm in December 1987 and is still retained by his oldest clients.

Over the last decade, Michael has been at the forefront of research in the financial services sector. He has reviewed most retail and wholesale financial products, and prepared reports analysing fees and premiums, market and legislative trends, market share and product features. He has also pioneered research into age pension dependency and trends, and has a keen interest in the integration of social security and superannuation.

Michael is well known as one of Australia's leading experts in the areas of distribution and product positioning and he has undertaken work for the ACCC, ASIC and IFSA to assist with major reviews or the implementation of new legislation.

He is currently a columnist for ASSET magazine. He previously wrote regular columns in Money Management, and Personal Investor. He writes and speaks frequently on topical issues affecting the funds management, life insurance and superannuation industries.

Michael has prepared a number of professional research papers including:

- Member Investment Choice
- Insurance in Super
- Analysis of the Australian retirement incomes policy
- "The Age Pension - Our Unstable Pillar", a new assessment of the role of Social Security in retirement incomes policy
- Restructuring Superannuation Funds in a Choice environment
- Financial Issues Facing The Nation (funding problems of an ageing population)
- Age Pension Statistics & Trends

Michael is a former Councillor of the Institute of Actuaries of Australia and is a member of a number of Institute committees:

- Public Policy
- FSR task force
- Ageing Australia Taskforce (Chair)

Michael can be contacted on michael.rice@pfac.com.au

A.2. Ian McEwin's Resume

Dr Ian McEwin specialises in law and economics including the economics of competition, corporate law and tort law. He has been an expert witness in major competition litigation in Australia and New Zealand (in telecommunications cases, the rugby Super League case, copyright issues and asset valuation disputes - including litigation to determine the value of satellite licences). Currently, he is a lecturer in economics at the Australian Defence Force College, University of New South Wales.

Dr. McEwin was a member of the Advisory Group of the Australian Law Reform Commission's reference on the Adversarial System. He was foundation chairman of the Canberra Regional Committee of the Business Law Section of the Law Council of Australia, and foundation Director of the Centre for Law and Economics in the Law Faculty at the Australian National University.

Dr. McEwin is currently a member of the Corporations Law Committee of the Australian Institute of Company Directors and the Trade Practices Committee of the Business Law Section of the Law Council of Australia.

Dr. McEwin has a PhD in economics and a first-class Honours degree in law, both from the Australian National University, and is admitted as a legal practitioner in the Australian Capital Territory. He has published widely in economics and law journals, and has held visiting positions at the Law School at George Mason University, Washington D.C.; the Centre for the Study of Economy and the State, Graduate School of Business, University of Chicago; and the Centre for Socio-Legal Studies, Wolfson College, Oxford.

B. Data Sources

B.1. Corporate Funds

We obtained annual reports and other published information from the following companies;

- Asahi
- Axa Staff
- BHP
- BOC Gases
- Boral Employers Super Trust (BEST)
- Boral (BSP)
- Coles
- CSC
- SCR
- David Jones
- Financial Synergy
- Fuji Xerox
- Fujitsu
- Hanimax
- Hills Industry
- Jupiters Ltd
- Kellogg
- MIM Super Plan
- Minda Super
- Qantas
- Shell
- St George
- Suncorp
- Telstra
- Uniting Church
- Woolworths

B.2. Industry Funds

We obtained reports from the following industry funds;

- Accountants
- Australian Retirement Fund
- ASSET
- C+BUS
- CARE
- Catholics
- Club
- Cue
- First
- Fin
- Health Super
- HESTA
- HIP
- Hostplus
- ISST
- Just

- MTA
- NGS
- NSF
- QCOS
- REST
- Sunsuper
- STA
- Statewide (SA)
- Tasplan
- Unisuper

B.3. Government Funds

We obtained reports from the following Government funds;

- AGEST
- CSS
- Emergency Services
- Energy Industries
- First State
- GESB
- GSO
- Local Authorities
- LG Super
- Local
- PSS
- Triple S
- State Pension

C. Planner Servicing Standards

C.1. Purpose

Authorised planners will be required to sign an acknowledgement of the required Servicing Standards and be expected to meet such standards in order to receive ongoing Service Insurance and AUM Commission.

C.2. Minimum Standards

The Planner Servicing Standards have been established with a view to assisting the Planners to identify a minimum level of servicing activity. In most instance however, success in Client retention will require more than merely satisfying these minimum standards:

1. Maintain regular and personal contact with the Client at the appropriate level (wherever possible, top manager/decision maker) to assist with AMP's retention and business objectives.

The Planner should:

- Make a minimum of four personal contacts with the company/trustees a year including as least one Client visit, and
- Be supportive of AMP initiatives to include Clients in seminars, workshops, luncheons and other initiatives.

The overall aim is to:

- Establish and maintain a personal long term relationship which benefits the Client, Planner and AMP,
- Provide an additional point of contact for the Client, and
- Enhance opportunities for cross selling within the company and particularly at the top management level.

2. Maintain regular and personal contact with the Business Relationship Manager (BRM) and Administrator in support of an effective team approach to servicing the Client.

The Planner should:

- Liaise with the BRM and Administrator so as to coordinate Client visits/contact and other service requirements
- Report on significant Client issues within a reasonable time frame to the BRM, and
- Participate in in-house joint meetings and training sessions arranged by AMP.

The overall aim is to:

- Ensure that the best resources are employed to develop business opportunities
- Keep all parties fully apprised of the latest developments with the Client and Plan, and

- Remain up to date on business opportunities arising from product issues, legislative and technical changes.

3. Respond to requests from and provide advice to Clients, assisted if appropriate by the BRM and Administrator.

The Planner should:

- Maintain a record of and monitor requests from, as well as responses to, Clients,
- Ensure that advice is provided in a professional and timely manner, and
- Actively seek business opportunities if appropriate in conjunction with specialist support staff.

The overall aim is to:

- Promote the value-added service of the Planner
- Position AMP as a professional provider of sound and practical advice, and
- Maintain and, where possible, further develop a relationship which is conducive to selling further business.

4. Respond to member questions if requested by the Client/employer.

The Planner should:

- Interview and enrol new members,
- Record and monitor member requests for information so as to provide professional and timely advice, and
- Provide salary packaging, financial/retirement planning and rollover advice through an accredited source.

The overall aim is to:

- Maintain and wherever possible enhance the value of the participation in the Plan by new and existing members,
- Maximise opportunities to write personal business in association with or upon exit from the Plan, and
- Enhance the value of added services provided by the Planner to the Client and members.

5. Implicit in the preceding servicing requirements are:

- That no actions will be taken that may jeopardise AMP's long term relationship with the Client,

- That the AMP' Code of Conduct will be adhered to in all aspects of servicing, and
- That all member and Client/company information will be held in strict confidence.