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Super savings

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Overview

Grattan Institute's 2014 report, *Super Sting*, found that Australians are paying far too much for superannuation. We pay about $21 billion a year in fees. That report proposed that government reduce fees by running a tender to select funds to operate the default accounts used by most working Australians.

The Murray Financial System Inquiry came to similar conclusions to those in *Super Sting*. Its 2014 report finds there is not strong competition based on fees in the superannuation sector. It recommends a "competitive mechanism", or tender, to select default products, unless a review held by 2020 shows the sector has become much more efficient.

This report analyses superannuation fees and costs in depth. It shows that there are excess costs in both administration and investment management. It evaluates recent policy initiatives to lower fees and recommends further reforms.

Our new analysis confirms the conclusions of our previous report. In both default and choice funds, administration fees are too high, and take a toll on net returns. There is little evidence that funds that charge higher fees provide better member services. There are too many accounts, too many funds, and too many of them incur high administrative costs. We pay $4 billion a year above what would be charged by lean funds.

Investment fees are also too high. Many funds do not deliver returns that justify their fees. Cutting fees to what high-performing, lean funds charge could save more than $2 billion a year.

In sum, superannuation could be run for much less than the $16 billion currently charged by large funds (self-managed super costs another $5 billion).

The superannuation industry argues that its $21 billion costs are not excessive, and will fall over time. It opposes a tender for default accounts based on fees, claiming that it would reduce investment quality and net returns.

But current initiatives to reduce costs are not enough. The Stronger Super reforms to reduce administration costs and make default products transparent will cut total default fees by about $1 billion. The Future of Financial Advice reforms could yield benefits for choice account holders. But even if regulators pursue these initiatives with zeal, they will leave billions on the table.

If remaining excess costs are not removed, they will drain well over 5 per cent – or $40,000 – out of the average default account holder's fund by retirement. Excess costs in choice superannuation are even larger.

Government must act to close accounts, merge funds and run a tender to select default products. The tender would save account holders a further $1 billion a year, and create a benchmark to force other funds to lift their game. A high performing superannuation system will take the pressure off taxpayers and give Australians greater confidence in their retirement.

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1. What superannuation is and why it matters

Superannuation is a compulsory private saving system that has become a large part of Australia's financial landscape since its introduction as a national system in 1992. The system holds $1.9 trillion in assets.[1] Australians pay about $16 billion a year in fees to collective funds to manage their superannuation, or more than $1000 per person. Self-managed funds cost about $5 billion more.

1.1 Contributions and tax treatment

Employers must contribute a proportion of each employee's wage to the employee's superannuation account.[2] The contribution rate, which started at 3 per cent of a wage or salary in 1992, is 9.5 per cent today, and is legislated to rise to 12 per cent by 2025.[3]

Individuals can make additional contributions to superannuation if they wish. Australians under 49 can put up to $30,000 a year from their pre-tax wages into their superannuation accounts and only pay 15 per cent tax on these contributions, while those older than 49 can contribute $35,000 a year. For many people, the 15 per cent tax rate on superannuation contributions is lower than if they saved the money outside superannuation. People can also make additional contributions from post-tax income. In 2013, employers paid $77 billion and individuals $36 billion into superannuation.[4]

Earnings on superannuation accounts are also taxed at what is a preferential rate for many people. Earnings are not taxed at marginal income tax rates but are taxed at a flat rate of 15 per cent until the account holder moves into pension phase (typically at age 60).[5] Once in that phase he or she pays no tax on the earnings of a superannuation account.[6]

1.2 Default and choice superannuation

Since 2005, most Australians have been able to choose their superannuation fund. A worker who does not actively choose a fund is allocated to a **default** product nominated either by his or her employer or specified in an industrial agreement. Superannuation funds manage about $468 billion in default accounts, about a quarter of all superannuation assets.[7] About 10 million people are in default superannuation, with about 18 million accounts in total. The average balance in default superannuation is currently about $25,000 per account and about $45,000 per person. Average default balances will grow strongly over coming decades, reflecting the high and growing contribution rates.

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[1] APRA (2014m).
[2] The requirement does not apply to employees earning less than $450 / month.
[3] 'Minerals Resource Rent Tax Repeal and Other Measures Act 2014 (Cth) Schedule 6'.
[4] APRA (2014a).
[5] Capital gains are also taxed at a concessional rate.
[6] Many argue that these tax concessions should be better targeted, but that issue is beyond the scope of this report: see e.g. Daley, *et al.* (2014), p.32-36; Financial System Inquiry (2014) pg 90; Treasury (2015); Fraser (2015)
[7] APRA (2014m).

All new default superannuation accounts must now be in a MySuper product. They are meant to be simpler and more comparable than previous default products. MySuper products must be invested in a diverse spread of assets. The types of fees that can be charged are limited and commissions cannot be paid.

The term **choice** is used to describe superannuation accounts other than defaults. The $1.5 trillion in assets managed in the choice segment are split between self-managed superannuation funds (SMSFs) and "large funds" of more than four members. The first group holds about $570 billion, the second about $930 billion.[8] We estimate that the average balance in the choice segment (excluding SMSFs) is about $110,000 per account, and about $160,000 per person, reflecting higher balances than default superannuation during the accumulation phase and a greater share of pension phase accounts. There are about 1 million people in half a million SMSFs, with average holdings per person of about $570,000.

1.3 Fund types

The 277 large superannuation funds (defined as funds with at least four members) hold $1.3 trillion of assets. Of these, about 150 manage more than $50 million.[9] These funds manage about 30 million accounts for about 15 million people.[10] In addition, a million Australians have superannuation in SMSFs.

Most superannuation funds are regulated by government agencies. The Australian Prudential Regulation Authority (APRA) regulates most of the 277 large funds. The Australian Taxation Office (ATO) regulates SMSFs.

APRA categorises large superannuation funds as industry, retail, corporate or public sector funds. Industry, corporate and public sector funds are typically run on a not-for-profit basis while retail funds are for-profit entities. Key differences among them include:

- **Industry** funds have historically "provided for employees working in the same industry or group of related industries." This distinction is less relevant today, but industry funds continue to manage the majority of default accounts.
- **Retail** funds offer superannuation products to the public. They have about 20 per cent of the default market in their own right. Australia's commercial banks and financial services company AMP operate the largest retail funds.
- **Corporate** funds exist "for the benefit of employees of a particular entity or a group of related entities, with joint member and employer control".[11] The fund often outsources all functions to a third party, typically a retail fund.
- **Public sector** funds are open only to government employees.

[8] Ibid..
[9] APRA statistics changed in September 2013 to include funds with less than $50 million in assets.
[10] APRA (2014a).
[11] Ibid..

1.4 How funds invest: asset classes and investment styles

Funds invest in a wide range of assets in Australia and overseas. About 80 per cent of the $1.3 trillion managed by collective superannuation funds – that is, excluding self-managed funds – is invested in listed assets or other assets such as cash or government bonds that are easy to buy and sell at short notice. The remaining 20 per cent is invested in less liquid assets such as property or infrastructure.

Funds offer account holders a range of multi-sector investment products. The products are typically invested across a number of asset classes in search of a balance between expected returns and risk.

Account holders can choose to allocate their wealth across a number of products. For example, they may retain some funds in a multi-sector product, and also hold one or more single-sector products. Account holders who do not explicitly make a choice are allocated to a default multi-sector product.

Fund trustees develop a multi-sector product by deciding how to invest across different assets. They also select investment managers, and they review their asset allocation and manager selection periodically, often with input from advisers known as asset consultants, with the goal of ensuring that the portfolio meets return and risk goals.

In turn, asset managers are responsible for delivering on the mandate agreed with the superannuation fund. They seek to achieve agreed risk and return goals, subject to agreed constraints such as what asset classes to invest in and how active to be in managing those investments. They will typically decide which individual stocks or bonds to hold and may retain some discretion to switch between asset classes.

In listed asset classes, managers may opt to be **active** – in other words, to retain discretion and exercise judgement about how to invest – or **passive**: that is, apply pre-set rules to define which assets to hold. Active styles are usually more expensive than passive styles. An example of a passive investment style is a capitalisation-weighted index fund. It buys and holds equities according to their market capitalisation. There are also hybrids of passive and active investment styles.

1.5 An efficient system helps account holders and taxpayers

Australians have a right to expect the best possible returns from their superannuation. For many, accumulated super savings will be a major source of income in retirement, so the better their returns, the easier their retirement. High net returns can also help government to reduce future pension payments and taxes.

Our 2014 report, *Super Sting*, shows that the Australian superannuation industry’s high average fees have a large, negative impact on returns. The precise impact depends on returns and income growth, but fees can make the difference between steak and spaghetti in retirement. An apparently modest fee of one per cent every year over a working life — lower than the average Australian fee — can be expected to reduce retirement income by more than 20 per cent.

An efficient superannuation system should provide good investment returns and appropriate member services at low cost. If the system were efficient, then reducing costs would impair member services or even reduce net investment returns after fees. By contrast, in an inefficient system such as Australia's, costs can be cut without impairing member services or net returns. Inefficiency can be caused by wasted costs in administration or in investment management, or both.

1.6 What this report does

This report examines how to cut waste in the Australian superannuation system.

Chapter Two assesses superannuation **administration**, and estimates how much leaner administration could save.

Chapter Three examines superannuation **investment management**. It reviews how fees affect net performance. It examines how investment managers perform against benchmarks and each other. It estimates how much leaner investment management could save.

Chapter Four, adapted from our 2014 report Super Sting, explains why fees are high in superannuation.

Chapter Five evaluates whether current policy initiatives over the next few years will cut costs, and by how much.

Chapter Six shows how further reforms could cut much more waste from our superannuation system.

2. Average administration fees are too high

This chapter examines the administration of superannuation – that is, all of the activities that a superannuation fund undertakes with the exception of investment management. In 2014 Australians paid collective superannuation funds (that is, all funds apart from SMSFs) $5.9 billion – $570 per person on average – to administer their accounts.

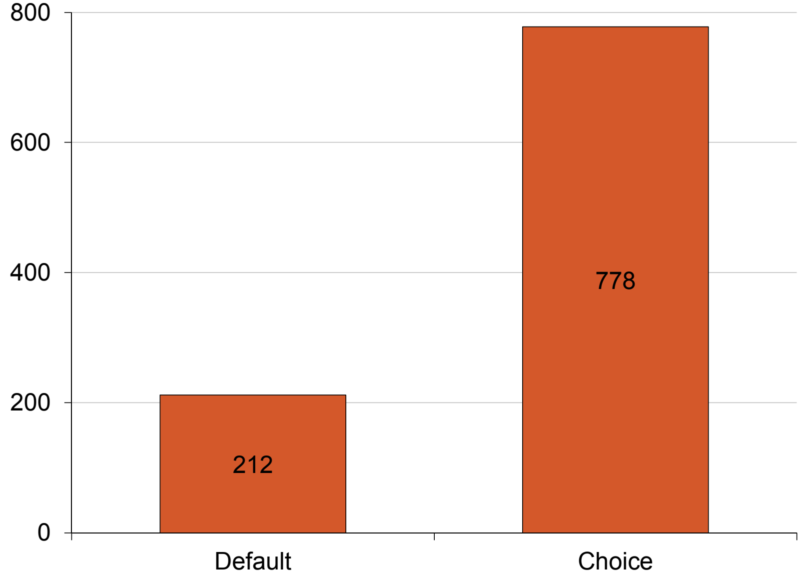
Default and choice fund administration fees are both about 0.45 per cent a year of average account balances. Members of choice accounts pay about $800 a year on average (Figure 1). Average account sizes are about $110,000 and people have 1.6 accounts on average.

Default fees are currently much lower in dollar terms. Accounts are about $25,000 on average, and average fees on an account that size are about $115. The average person with a default account has just under two accounts, so administration fees are about $212 per default member.

Administration fees in choice and default superannuation are higher than they need to be for three main reasons. First, about 12 million superannuation accounts are not needed. Second, there are still too many funds. Third, many people are in funds that are inefficient or provide low-value services.

Figure 1: Administration fees are over $200 per person in default superannuation and almost $800 in choice

Dollars per representative member



Notes: Assumes the average number of accounts per person in that segment (1.85 in default, 1.6 in choice).
Sources: Grattan analysis.

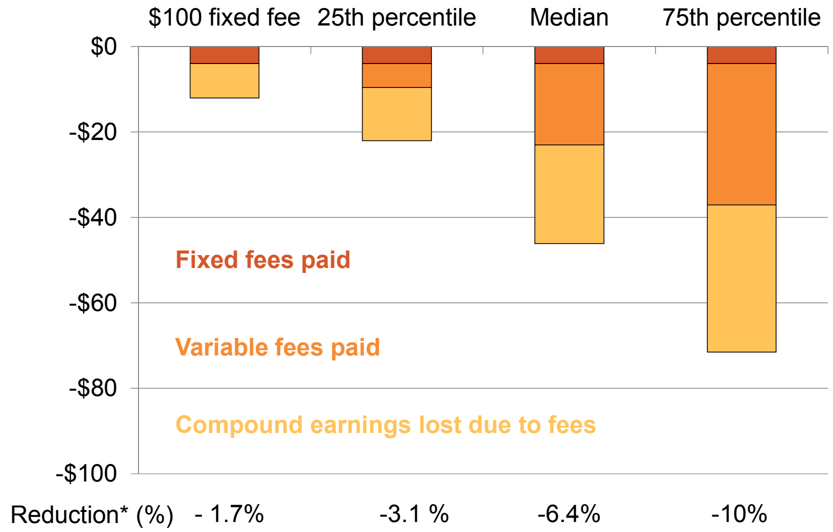
2.1 High administration fees reduce retirement incomes

High administration fees reduce retirement balances in both choice and default superannuation.

The median administration fee paid on a single default account is only a little higher than $100 today because the average account balance is small. But fees grow over time: many products levy administration fees as a percentage of assets under management, so the average dollar fee will increase as the system matures and account balances increase. Even the median administration fee is big enough to reduce retirement balances by more than $40,000 over a lifetime (Figure 2). The variable fee cuts retirement balances much more than the fixed fee, as Figure 2 shows.

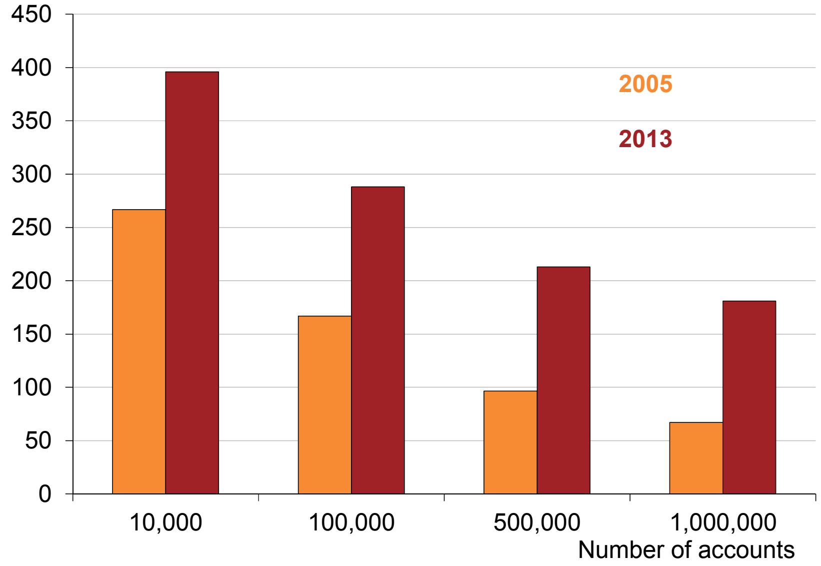
Administration expenses per account have risen steadily since 2005 despite steady fund consolidation. Funds of all sizes now report much higher administration costs than they did in 2005. For example, administration costs for a fund with 500,000 members rose from about $100 to $200 per account in constant dollars (Figure 3).

Figure 2: MySuper administration fees reduce retirement balances
$ Thousands – reduction in superannuation balance at retirement due to administration fees – MySuper products.



Notes: Assumes 40 year contribution period; 1.8 per cent real wage growth; 5 per cent real investment returns (net of tax); starting wage $45,000; contributions 10% of wage. Does not adjust for capped fees (e.g. Mercer caps administration at $600/year, QANTAS caps total fees at $1300/year). Variable administration fees for the 25th, 50th and 75th percentile are 0.06%, 0.2%, and 0.38% respectively.
Sources: Grattan analysis of APRA (2014m), OECD (2012).

Figure 3: Administration expenses have risen for all fund sizes
Average administration operating expense per account - $2013



Notes: Grattan analysis of fund APRA reported 'total operating expenses'. Values are those predicted by a linear-log model of operating expenses as a function of the number of accounts. Omitted funds with operating expenses >$2,000/account and with <5,000 members. Not adjusted for inactive accounts: the adjusted scale curve is slightly flatter but the increase over time is the same when adjusted. The costs of both industry and retail funds rose.
Sources: APRA (2014i).

Factors that have led to the cost increases shown in Figure 3 include regulatory and reporting requirements, the capital costs of the Stronger Super reforms and the cost of updating so-called legacy products (products that, while no longer actively marketed, must still be compliant with new reporting requirements). Costs also rise as funds compete for members with costly sales, marketing, and member engagement efforts, and when they add products and services. Individual funds may do those things to grow and protect market share, intending to pass on the resulting benefits of scale to account holders. Funds may feel "compelled to take on more expense... implementing expensive administrative arrangements… which relatively few members will utilise."[12] But when many funds are taking similar steps, few funds gain market share, so average costs rise. And the extra services may not provide much real value to account holders.

Fund mergers and scale increases may have prevented even larger cost increases. Figure 3 shows the benefits of scale: funds with more accounts charge lower administration fees per member. In 2005 there were 183 superannuation funds managing over $50 million of assets open to public enrolment, with 77,000 accounts on average.[13] In 2013, this had fallen to 147 funds with 148,000 accounts on average.[14]

2.2 First inefficiency: too many unwanted accounts

Excess accounts contribute to high administration costs in Australian superannuation. Some people actively choose to maintain two or more accounts: for insurance, to reduce taxes, to diversify, or because one of their accounts includes a defined benefit. But many others fail to consolidate accounts as they

[12] Vidler (2010).
[13] APRA (2014a). Funds with >$50 million in assets due to APRA reporting. Public-offer funds as defined by APRA, excluding corporate products branded 'public offer' funds when they cannot be accessed by the general public.
[14] Ibid..

switch jobs, and end up with more accounts than they want or need.

About 14.5 million people own 30 million accounts held in non-self-managed superannuation funds.[15] In other words, there are 15.5 million more accounts than people. Perhaps only three or four million of these extra accounts are needed.[16] The 12 million excess accounts[17] add about six per cent, or $360 million, to total administration costs, as the additional cost of servicing a single inactive account is about $30.[18] The main costs of administering an inactive account are creating and distributing account statements and other member communications.

Because default account holders are more likely to hold unwanted accounts, they are likely to bear about $300 million of the $360 million cost of multiple accounts.

Closing these excess accounts will reduce costs, and fees will fall if the reductions are passed on. People who have more accounts than they need would benefit. But people who have one account today may end up paying more. Fixed account fees average about $70 in MySuper (probably more in the rest of the market), or more than double the additional costs of administering an inactive account. Removing 12 million excess accounts with fixed fees of $70 each would therefore reduce fees by $840 million. Funds would probably seek to recoup lost revenue by increasing fees per account.

2.3 Second inefficiency: too many funds

There are too many superannuation funds, all performing similar activities and duplicating costs. Removing duplication with a round of fund mergers could save at least $500 million.

Running a superannuation fund involves some fixed costs that are largely separate from the number of members it serves. They include setting up the product range, building technology and compliance platforms, and paying for general management and trustee functions.

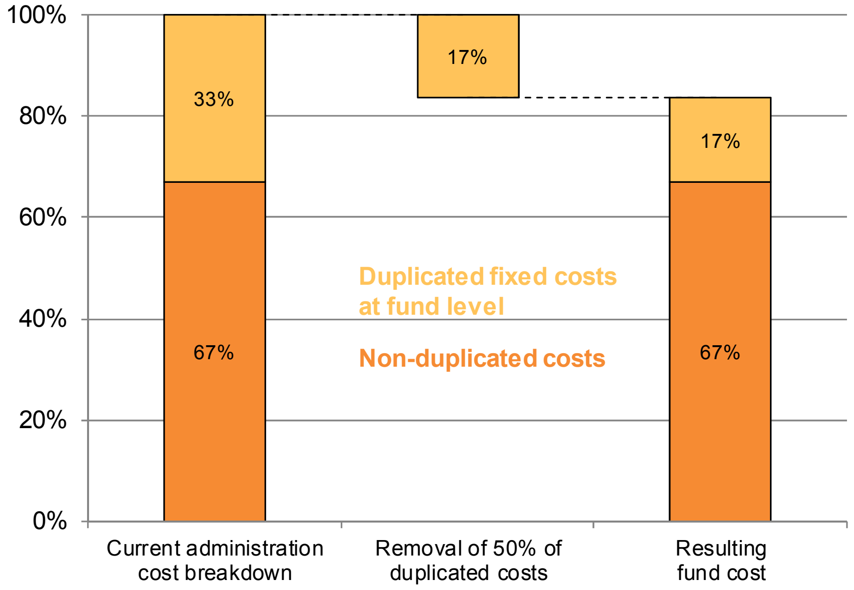
Fixed costs account for about a third of the administration costs of an average superannuation fund.[19] If a fund were to close and all its accounts were transferred to other funds, about a third of the administration costs for those accounts could be eliminated from the system, and total administration costs across the two funds would fall by about a sixth (Figure 4).[20]

Smaller funds can reduce fixed costs by outsourcing, or by just doing less in some cases. Savings from a merger can take time to

[15] Discussions in 2015 with the ATO suggest that the number of people with superannuation in APRA-regulated funds is between 14.5 and 16 million. Given most public sources suggest that the total is lower, we adopt the bottom of the range. APRA (2014i) reports that there are 30 million accounts. A million people have accounts in SMSFs.
[16] Clare (2007) estimated that there were four million wanted non-primary accounts in 2007.
[17] There are four million small accounts in Eligible Rollover Funds (ERFs).
[18] Grattan analysis of Rice Warner data in ASFA (2014).
[19] Analysis of ibid. , SuperChoice (2009) & SunSuper (2014).
[20] The analysis presented in Figure 3 is also consistent with about 1/3 of total administration costs for an average fund being fund-level fixed costs. The average administration cost of funds with 500,000 accounts are 26 per cent below the cost of funds with 100,000 accounts and about 10 per cent above the cost of funds with 1 million accounts.

be realised and are not guaranteed. But the strong relationship between unit costs and fund size (shown in Figure 3) suggests that over time the resulting increases in average fund size will help to reduce costs.

Figure 4: Fund mergers could cut administration costs by one-sixth
Per cent of administration costs



Notes: For an average fund.
Sources: Grattan analysis of ASFA (2014), SuperChoice (2009), SuperPartners Pty Ltd (2013), Australian Administration Services Pty Limited (2013).

Mergers would cut costs in both the default and choice segments. The opportunity for savings is likely to be larger in the default segment because there are relatively few constraints on mergers between industry funds, which predominantly serve that segment.

The 50 or so industry funds charge total administration fees of about $1.6 billion.[21] If each of these funds merged with one of a similar size and cost structure, creating about 25 industry funds, total administration expenses could be about a sixth, or $270 million, lower. The 160 or so retail and public sector funds charge about $3 billion in administration fees. Mergers among public sector funds may be difficult where one or both funds manage a defined-benefit plan, as each current plan sponsor may have ongoing liabilities. Similarly, the relatively concentrated retail segment may have less opportunity for mergers. If just a quarter of funds merged into existing ones, savings could be close to $260 million.

Perhaps $350 million in savings across fund types would accrue to funds and account holders in default superannuation, with the rest accruing in the choice segment.

A range of challenges could hinder any specific fund merger: legacy products (products that are no longer open to new accounts, but in which people retain accounts) and defined benefit interests can make it hard or impossible to consolidate a fund, for example. But despite potential difficulties, the merger of a number of funds appears feasible. Even widespread consolidation is unlikely to restrict choices for account holders.[22]

[21] There were 52 industry funds and 165 retail and public sector funds in June 2013. APRA (2014a).
[22] The very largest fund in the default part of the market has about 1/6 of the default market (and 1/15 of the entire public offer market), so only mergers between the largest funds could pose concerns about competition in that market.

2.4 Third inefficiency: many funds charge high administration fees

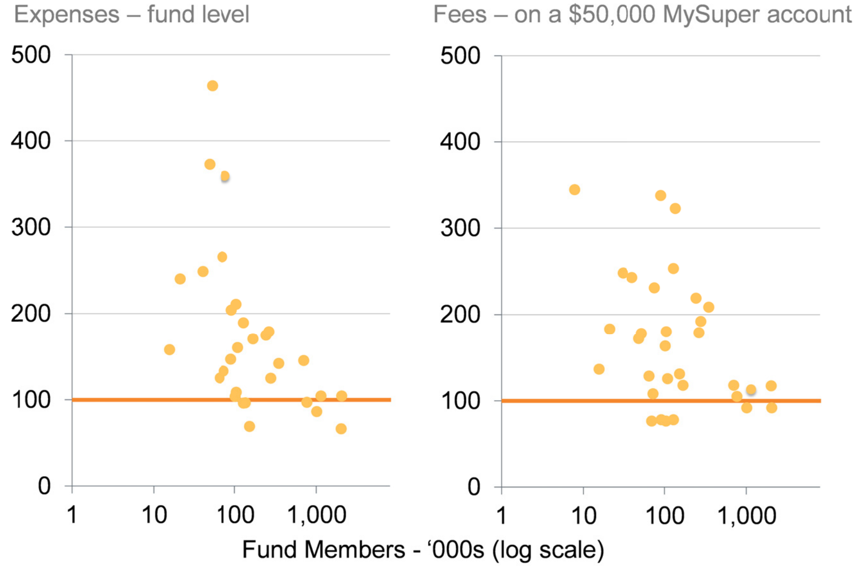
Many funds charge much higher administration fees than lean funds do. Lean funds charge administration fees of just $100 per account, compared to a system average of $230. In the default market, fees today are not much higher than $100 per account – a reasonable benchmark for default administration fees given the superannuation system's market structure and current technology.

Some funds of all types (industry, retail, public sector, and corporate) report expense ratios and charge administration fees of little more than $100. But the operations of industry funds offer the more reliable guide to attainable costs, because they are less likely to share costs among different business areas.[23]

The lowest-cost funds' expenses per member all sit at about $100 per year (Figure 5), even after adjusting for the varying proportions of inactive accounts.[24]

Independent benchmarking studies of funds' cost structures also suggest that $100 per account is attainable given current rates of inactive accounts. One study of 10 not-for-profit funds found that the median administration expense was $117 a year in 2013.[25]

Figure 5: Lean funds administer accounts for $100 today
Administration expenses and fees per account



Notes: The number of MySuper members are not published by APRA; the chart in the second panel assumes product membership as if all accounts were $50,000. The left panel excludes two products with operating expense greater than $500 per person. If the operating expenses shown in the left panel is adjusted for contributions per account (generated by a linear regression of operating expenses against contributions per account), fewer funds have costs that are below $100 per account.
Sources: Grattan analysis of APRA (2014i), APRA (2014m).

[23] Costs reported by retail and corporate funds may be affected by how costs are allocated between superannuation and non-superannuation arms of integrated businesses, between investment and administration, and between superannuation products managed by the same firm.
[24] Funds that report operating expenses of around $80-90 per member appear to benefit from a large proportion of inactive accounts.
[25] CEM Benchmarking report accessed in SunSuper (2014).

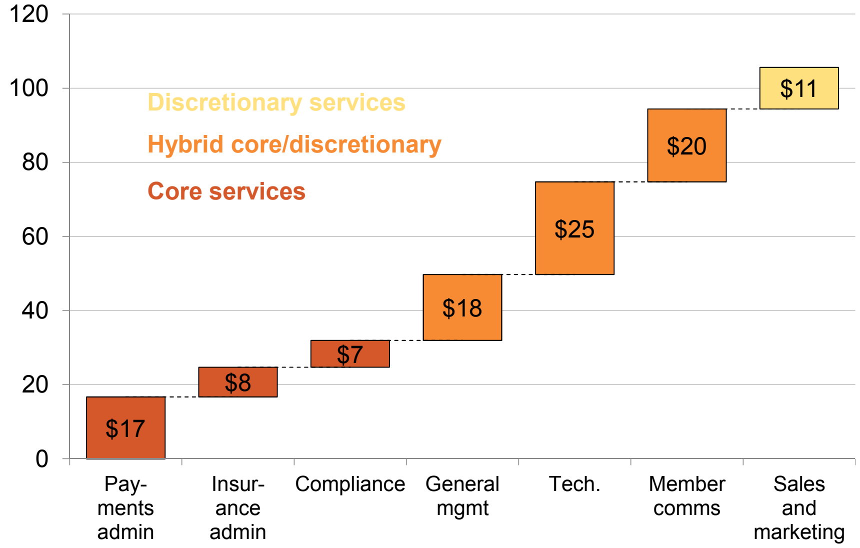
Another benchmarking study of 12 larger-than-average funds found the median administration expense to be $106 per account in 2013.[26]

It is difficult to assess what contributes to the gap between the administration fees charged by the leanest funds and others, including choice accounts. Administration expenses can be grouped into three categories:

- The costs of efficiently provided core services, such as payments, insurance claims processing, compliance, and basic member communications.
- The costs of efficiently provided and valuable additional services. Members' benefits may exceed costs for some, but not all, communications, advice platforms, and investment choices.
- Excess costs, such as inefficiently provided core services, or lower-value services such as marketing and sales effort, costly member communications, or overly diverse product lines.

At least half of the administration costs of a large and relatively efficient fund are likely to be dedicated to core services (Figure 6). The average fund – charging on average over twice as much as these funds – must either be operating core administration functions at higher cost or spending much more on discretionary services.[27]

Figure 6: Lean funds spend little on discretionary services
$ operating expense per function per account



Notes: Each data point is the median from each category (the median of the components totals $106, the median administration cost is $105). The sample is a peer group of relatively large not-for-profit funds.
Sources: Rice Warner research, published in ASFA (2014).

[26] Rice Warner research as presented in ASFA (2014).

[27] A frequently cited contributor to the high costs of superannuation is that Australian funds must process insurance claims. It is unclear what the average costs of administering insurance claims and processing are, but a sample of 12 large funds spent just $8 per member on it (Rice Warner research, published in ASFA (2014)).

Such additional services cost many account holders tens of thousands of dollars over their working lives. To be justifiable, they would have to create more than that in value for members.

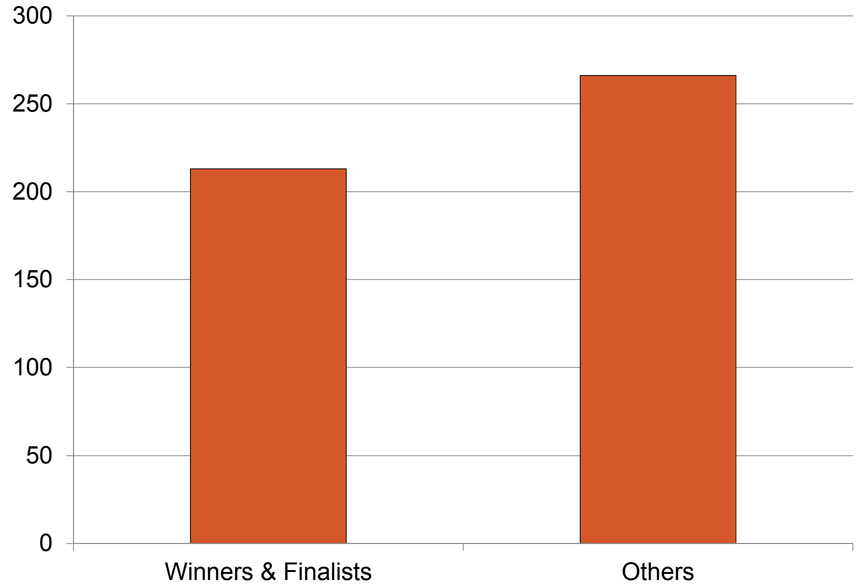
Some evidence suggests, however, that extra administration costs may not create much additional value for account holders. Funds with high administration costs do not appear to provide more valuable member services. A survey of account holders shows that they do not value the member services of funds with high fees and operating expenses any more than those of low-fee funds.[28]

Research firms also do not appear to rate more expensive funds more highly. The funds that superannuation research firms recognise for their member services report lower average operating expenses and administration fees than the funds that are not recognised for their service (Figure 7).

From the point of view of each fund, spending on discretionary low-value services may be justifiable if it helps retain existing members and win new accounts. Building membership can help funds provide scale benefits to members. But policymakers should see these costs as contributing to the superannuation system's failure to reach its prime goal – providing retirement incomes to replace or supplement the age pension.

Figure 7: Funds recognised for member services are not more expensive

Fund reported operating expense, $2013, unweighted mean.



Notes: 11 'winners and finalists' (one winner and ten finalists) listed by Chant West and ten listed by Selecting Super. Public-offer funds that currently offer MySuper (14 winners, 45 non-winners) are included in this analysis. When expenses are FUM-weighted, non-winners' fees are much higher. Award winners also charge lower MySuper admin fees (unweighted & FUM-weighted). Chant West winners are judged on three sub-criteria: communication materials (40%), education (40%) and advice services (20%). Selecting Super winners are 'personal Super products with the most extra benefits and services offered'.

Sources: Grattan analysis of Selecting Super (2013), Chant West (2014c), APRA (2014w), APRA (2014m).

[28] CHOICE Australia (2010). Respondents were asked: 'Rate your satisfaction with the level of customer service' on a 1-10 scale. There were 496 respondents to this question whose superannuation fund could be matched to products in existence in 2010. Respondents were also asked 'Rate your satisfaction with the fund's call centre' (n = 382). Respondents did not rate more expensive funds more highly on this measure either. Both measures of a funds' services were also unrelated to MySuper fees in 2014 and the per-account operating expense in dollars in 2010 and 2014.

2.5 There are large potential savings in default and choice administration

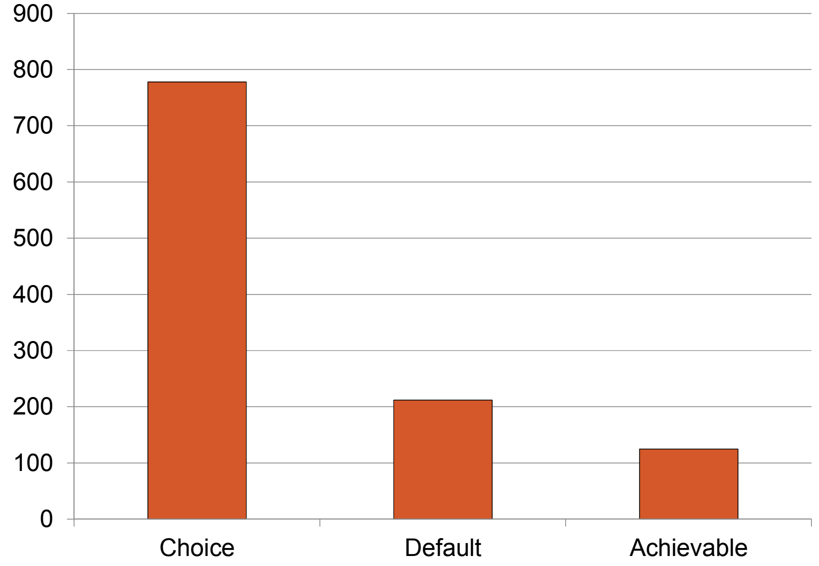
Administration fees per person in default funds are about $210 a year, when they could and should be $125 (Figure 8). In total, there is about $750 million of excess costs in default superannuation today. Excess accounts, subscale funds and excess cost in some funds all make a contribution. Default account holders are likely to bear around $300 million of the $360 million cost of multiple accounts. They also bear about $350 million through the burden of an excess number of funds.

Many people in MySuper products do pay low administration fees today. People with a single account in a lean fund can pay under $100 a year. But people in higher-cost funds, or the many people with multiple accounts, pay much more. As accounts grow, administration fees will rise for all account holders who pay variable fees.

Fees in the choice market are much higher. A move towards $100 per account in the choice market could save more than $2 billion a year and put many tens of thousands of dollars in accounts at retirement. Funds may provide additional services and options in the choice segment. The segment is more costly for funds to operate in, as they have less recourse to wholesale forms of competition. Instead, they market directly to individuals and firms. $100 per account may be a useful point of comparison to determine whether choice products are providing sufficient value.

Figure 8: There are large potential administration cost savings in default and choice superannuation

Estimated administration fees per person in default and choice sectors, $ per year



Note: Does not include reductions in advice costs. Model is based on average account sizes of $25,000 for default and $110,000 for choice, 1.85 accounts per person for default and 1.6 for choice. The achievable cost factors in 1.1 accounts per person in default accounts after excess accounts are consolidated. Choice includes pension products.

Sources: Total FUM in each sector (APRA), from number of people with superannuation (ATO, ABS), and total number of accounts (APRA).

3. Average investment management fees are too high

High investment management fees also reduce the superannuation balances of many Australians. Account holders pay about $7.9 billion a year in investment management fees, about 0.6 per cent of their balances. The range of fees in MySuper products is wide: from about 0.3 per cent to more than 1 per cent a year.

Some account holders are doing well; others are paying too much for their investments. Overall, Australians pay at least $2 billion more than they would if all funds charged the fees that the leanest high-performing funds charge. [29]

Larger savings beyond this $2 billion may be possible. Broader use of fund managers whose approach to investment management is less active than others could save at least further $750 million.[30]

3.1 Many are paying excessive investment fees

Grattan's 2014 report, *Super Sting,* showed that total fees – the sum of administration and investment fees – are eroding returns.[31] Some analysts acknowledged that some funds do charge excessive investment fees, but said there was little evidence that funds that charged more moderate investment fees were charging too much.[32] In response we have undertaken further analysis to focus on investment performance. The findings suggest that on average many Australians are paying too much for investment management of their superannuation.

When we compare superannuation products with similar investment strategies, higher-fee products generate lower returns over the long run than their lower-fee counterparts. This is the case in many single-asset-class products, which invest in just one type of asset, such as cash, Australian equities, or Australian fixed income.

Even in so-called multi-sector products, which invest in a wide range of asset classes, there are many overpriced products that clearly underperform, though varying asset allocation between multi-sector products can obscure the impact of fees.

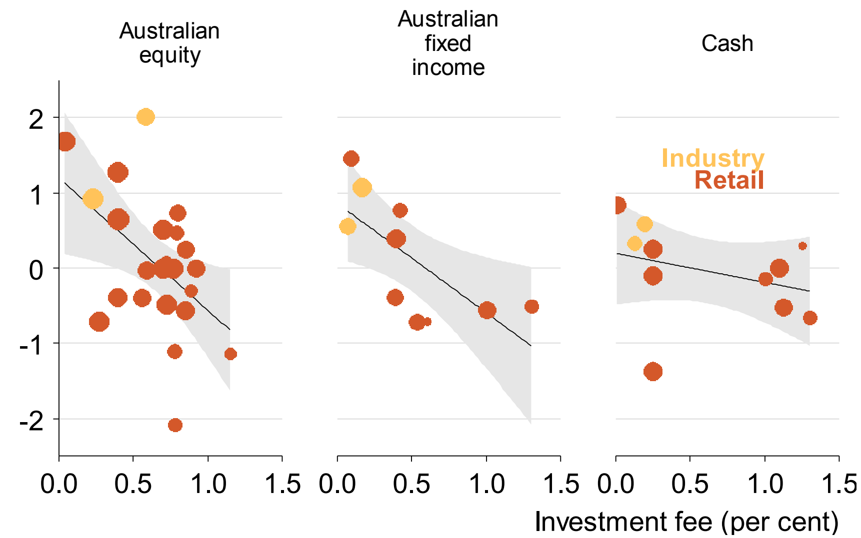
[29] Figure excludes investment fees paid by self-managed superannuation funds, estimated at about $3 Billion (Rice Warner (2014)).
[30] The figure of $750 million is reached by taking the retail fees for such products today as a guide. Wholesale fees are lower and may be more reflective of the costs account holders in large funds would pay.
[31] {Minifie, 2014 #321}.
[32] See Mercer (2014b) for example.

3.1.1 High-fee single-sector products have lower returns

Within some single-asset-class products, higher investment fees are associated with lower returns.

Figure 9 shows that higher fee products are associated with lower returns for the major Australian-listed asset classes, which make up the largest share of Australian superannuation investments.[33] The relationship is strong in fixed income. Australian equities produce a greater spread of returns, but the link between high fees and low returns is also strong, and statistically significant at the 95 per cent confidence level. A broad spread of returns is to be expected, because the group of Australian equity products includes funds that follow very different investment strategies.

Figure 9: High fees reduce returns in Australian asset classes
Per cent annual returns relative to peers after investment management fees, 2004-14



Notes: A single investment management product is often available at different fees across different funds and platforms. We use the lowest fee at which each product is available & its total FUM across funds and platforms.
Sources: Grattan analysis of Morningstar Direct Australia Superannuation Funds dataset.

International products are more diverse than domestic investments: some are hedged against currency movements, some unhedged; they may offer exposures to different regions that face different risks. The dataset has too few observations to provide any basis to draw conclusions about how fees relate to net returns in these product classes.[34]

[33] The analysis uses a dataset of investment fees and returns of superannuation products maintained by the private data provider, Morningstar. It includes superannuation products that are available to any member of the public, but not those of public sector and corporate funds available only to employees of particular organisations ('non-public-offer' products). We exclude all products designated by Morningstar as closed; all products that have front or back loading fees; and all products for which the management fee is zero, greater than 1.5, or equal to or greater than the indirect cost ratio. For each investment manager in each Morningstar category we extract the manager's product offered at the lowest investment fee. These screens remove many actual high fee products but reduce the risk of using misreported investment fees. The average of these fees across all products and asset classes was 0.6 per cent a year in 2014. That is close to the average fee across the entire superannuation sector (including the fees of non-public offer products). The measure of returns net of investment fee used is the net return plus the indirect cost ratio minus the investment fee.

[34] The relationship is not significantly different from zero for international equity and international fixed income.

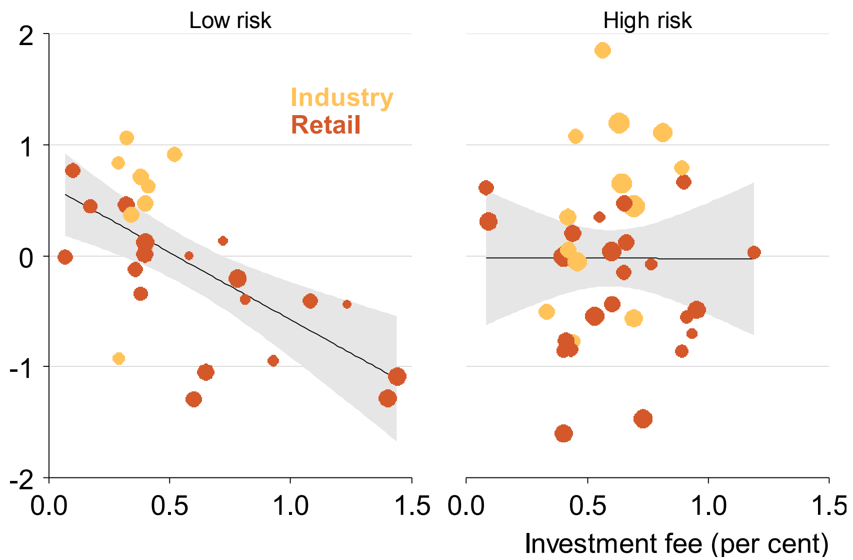
About 20 per cent of superannuation investments are in unlisted and alternative asset classes, including directly-held property and infrastructure, private equity, and hedge funds.[35] Within these products, investment fees are important to returns. Using the fees and returns of unlisted assets managed for 28 global leading pension funds, CEM, a respected benchmarking firm, concluded that the "performance differences are primarily due to cost differences".[36]

3.1.2 Fees and returns in multi-sector products reflect asset allocation

Multi-sector products offer exposure to a range of asset classes. They have the largest share of superannuation assets and all MySuper products are multi-sector products. Figure 10 shows how investment fees relate to net returns in a large (but not complete) dataset of multi-sector products.[37] It shows that across products with lower exposures to risk, higher fees are linked to lower net returns.[38] Among the higher risk products, there is much more variability, reflecting large differences in investment strategy and asset allocation, and no discernible relationship to fees.

Figure 10: High fees reduce returns in some multi-sector asset classes

Per cent annual returns of multi-sector products relative to their peers after investment management fees, 2004-2014



Notes: A single investment management product is often available at different fees across different funds and platforms. We use the lowest fee at which each product is available & its total FUM across funds and platforms. Low risk includes Morningstar's Conservative, Moderate and Balanced categories; High Risk includes Growth and Aggressive categories.
Sources: Grattan analysis of Morningstar Direct Australia Superannuation Funds dataset.

[35] APRA (2014w).
[36] Heale (2014).
[37] The dataset is screened according to the same rules used in Figure 9. The dataset excludes non-public-offer products such as those made available to public servants by public sector funds or by corporate funds to their employees.
[38] The lines in Figure 12 indicate the average relationship between fees and returns within each risk category. An increase in investment fees of 1 per cent produces an average decrease in returns of 1.1 per cent in the lower-risk group. The shaded areas indicate 95 per cent confidence bands.

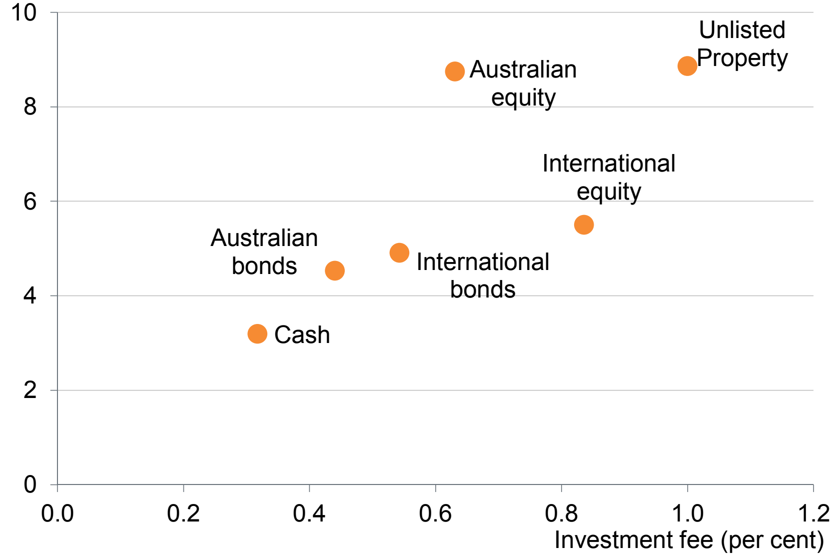
Figure 10 also shows that some industry funds have outperformed others that charge similar fees. In the lower-risk group, industry funds are relatively low cost (but still outperform others). In the high-risk group, their average fees are not particularly low.

Many industry funds have recorded good performance because they have strong exposures to asset classes that have performed well. In 2013 industry funds as a group (including funds not included in our dataset and so not displayed in Figure 10) had about 29 per cent of their investments in unlisted assets compared to an average in non-industry funds of about 16 per cent.[39]

Those asset classes have produced higher returns over the last decade, and they also cost more to manage (Figure 11). The figure shows fees and 10-year net real returns for five liquid asset classes and for unlisted property, a less liquid asset class. Average fees for publicly available products vary from under 0.3 per cent for cash to about 0.8 per cent for international equity. Unlisted property fees routinely exceed one per cent. Unlisted infrastructure, not shown on the chart, can cost much more than 1 per cent to operate and has generated strong returns for many funds.[40]

Figure 10 may give the impression that fees do not matter much in the high-risk multi-sector products. But to draw that conclusion would be a misunderstanding. Multi-sector products are assembled from single-sector exposures, so fees remain key to good performance in them as well.

Figure 11: More costly asset classes have performed strongly
Nominal net returns, per cent 2004-2014



Notes: Fees are for the sample in Figures 9 and 10, except for unlisted property. Direct property investment fees were not available in the Morningstar dataset. Industry consultation suggests that investment management fees for unlisted assets exceed 1 per cent.
Sources: Grattan Analysis of superannuation products currently available and listed in Morningstar's superannuation database. Direct property returns are from Morningstar's Median Unlisted Property index.

39 APRA (2014m).
40 Cummings and Ellis (2011).

3.2 Lean high-performing funds charge fees well below the MySuper average

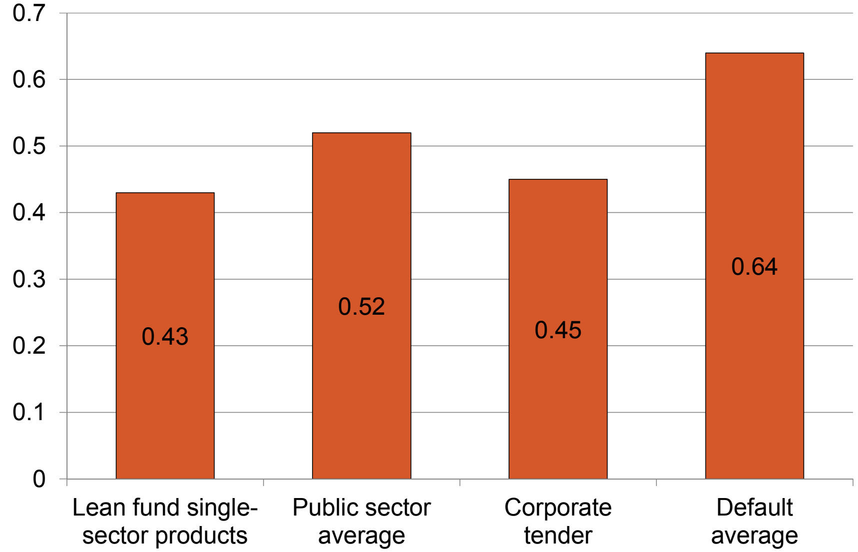
The above sections show that within asset classes, lower-fee products tend to perform better than others, and that asset allocation is also important to returns. But what is an appropriate target for fees?

Figure 12 compares today's MySuper average fee with the fees of lean high-performing funds, public sector funds, and large corporate tenders. These three quite different groups all have fees that are significantly lower than the system average of about 0.6 per cent and the MySuper average of 0.64 per cent.[41]

The investment fees of public sector funds are about 0.52 per cent a year, as shown in Figure 12.[42] Public sector funds as a group have achieved the highest average net returns over the 14 years to 2013.[43]

[41] The MySuper fee is a FUM-weighted average, including an allocation of accrued default amounts to their probable destination MySuper products.
[42] Research firm Chant West estimates public sector investment fees are 0.45; Rice Warner (2014) estimates them as 0.52. It is likely that these funds offer more exposure to unlisted assets than the system average. If their investment fees were applied to system average asset mix they may be 0.05 per cent lower.
[43] Source: APRA (2014w). Their average annual returns exceeded those of the entire APRA-regulated superannuation industry by 1.1 percentage points, industry funds by 0.6 percentage points, and retail funds by 2.2 percentage points per year over that period. Some of the differential in net returns is due to lower administration fees but administration fees cannot account for all of the difference.

Figure 12: The average annual default investment fee is 0.2 per cent higher than that of today's high performers
List and corporate investment fees for an otherwise identical product



Notes: Lean fund single sector products are applied to system average asset allocation; public sector average is probably higher in more costly unlisted products than system average; the corporate fee is for large tenders (see note in the text).
Sources: Rice Warner (2014); APRA (2014m); Grattan analysis.

The 'lean fund single-sector products' fee in Figure 12 is for a group of low-fee, high performing funds.[44]

[44] 20 funds are chosen based on their size in 2014, performance over the ten years 2005-2014, and data availability. The source is the funds with the highest-performing default products in SuperRatings (2014b) for the 10 years to 2014 supplemented by the ten funds with the largest MySuper products in 2014, as

Large corporate tenders also pay relatively low investment fees, averaging 0.45 per cent, as Figure 12 shows.[45] Fees are often significantly below the fees of equivalent products offered to smaller customers. For example, one large corporate product has an investment fee of 0.45 per cent. It and a MySuper product with an investment fee of 0.61 per cent per year are managed by the same fund and are invested identically.[46]

The lean high performing funds and public sector funds do things differently to other funds, helping to reduce costs. Many of the funds are non-profit, possibly making a contribution to low fees. Typically they manage large portfolios. Their scale can reduce the fees they pay to external asset managers. It can also make in-house asset management economic and permit funds to implement cost saving measures such as centralised portfolio management.[47] Their example suggests that one way to reduce average investment fees in superannuation is by more widespread adoption of the scale and investment style of these large lean funds. The tender recommended in Chapter 6 would increase the share of default superannuation managed in this way.

The same forces make it possible to set low investment fees for corporate tenders. It can be efficient to place additional tranches with an investment manager who is already managing assets on behalf of a fund. Selling costs can also be much lower than for products sold to smaller firms and individuals, and some superannuation funds may elect to charge a lower operating margin on investment management fees. Either way, the low investment fees achieved could be more broadly emulated if more superannuation investment were organised in large tranches.

3.3 Less active investment styles may further reduce fees

This section provides additional evidence that Australian superannuation investment management may be provided for less. To assess whether Australian equities managers could cut costs and maintain performance, we created individual benchmarks for 64 Australian investment managers following a well-established approach from the finance literature called factor analysis.[48]

To make the benchmarks, we used a few easily observed attributes of the firms traded on the Australian stock market, known as factors. Over a period of time, share market performance may be high for small companies (the size factor), or for companies whose share prices have already risen recently (the momentum factor), or for companies whose accounting values are high compared to their market values (the value

identified by Chant West (2014a). The fee is calculated as follows. We collect the funds' default and single-asset class product fees for cash and Australian and international fixed income and equities. We extract an implied fee for other asset classes using this information and the asset allocation of the default products. We calculate the fee of the 20th percentile product in each asset class (that is, the fee that is above 20 per cent of products' fees, and below 80 per cent). We conservatively apply the 40th percentile implied fee for 'other' assets. Applying those fees to the asset mix managed by the superannuation system gives an average fee of 0.43 per cent a year.

45 Rice Warner (2014).

46 Sourced from Fair Work Commission submissions and product disclosure statements.

47 Williams (2014).

48 Carhart (1997); Cremers, *et al.* (2012).

factor). In constructing the individual benchmarks, we use these factors as well as the broader market. We find the factor portfolio that best mimics each manager's strategy, by calculating how that manager's performance correlates with the performance of the four factors.

Figure 13 shows the performance of these 64 Australian large-cap equities managers against the ASX 200 accumulation index (a common market benchmark), and against their individual benchmarks. It shows that most managers outperformed the market benchmark. (For this exercise, we take the data at face value, but see the Box to the right for reasons why historical fund performance data can be biased in favour of showing outperformance). Most managers underperformed their individual benchmarks.[49] About the same proportion strongly outperformed their individual benchmarks (5.5 per cent) as would be expected as a result of chance (5 per cent).

Similar results have been found internationally: much mutual fund performance across many countries seems to be largely explained by exposure to factors.[50] Much of the additional value appears to be generated by momentum: that is, funds that do well typically hold shares that rise over successive periods rather than successively identifying shares that rise.

Can asset managers outperform on average?

Investment managers are compared to market benchmarks in assessing whether they provide value for money. Many perform about as well as their benchmarks before fees because their holdings are very similar to their benchmark (Petajisto (2013)). A few managers beat the market over the long term.[51]

In some markets, over some periods, even the median institutional investor appears to beat the market. Such findings can be due to mismeasurement. Lower-performing managers are more likely to drop out of many datasets (survivorship bias). Even surviving managers may tend to report historical returns that are more favourable (so-called "backfill bias"). Managers may take greater risks than common benchmark indices and may not outperform after adjustment for risk or asset class.[52]

The median fund may outperform if others – foreign or individual investors, or a few institutional funds – underperform. Meyer *et al.* (2012) show that individual investors in Germany underperform the market. AMP (2014) notes that Australian individuals may make mistakes that institutional managers avoid. Some managers may pay lower transaction costs, or have opportunities that retail investors do not, such as preferential access to capital raisings.

But even genuine outperformance may be achievable at lower cost. This is explored in the text.

[49] We also constructed a version of the analysis that uses only data available at each point in time. The analysis has less statistical power, but the median fund does not outperform the resulting forward-looking benchmark.
[50] For the US, see Carhart (1997), and Fama and French (2010). For the UK, see Cuthbertson, *et al.* (2008). For a review of the correlates of mutual fund performance across 27 countries, see Ferreira, *et al.* (2012).

[51] Fama and French (2010) find that a slightly larger proportion of US mutual fund managers outperform over the long run than would be expected by chance.
[52] See Carhart (1997) for an introduction.

A manager that undertakes the costly task of researching and selecting individual stocks (and charges fees to cover those costs) should be able to beat its individual benchmark. What should we make of managers who beat a broad market benchmark but not an individual benchmark?

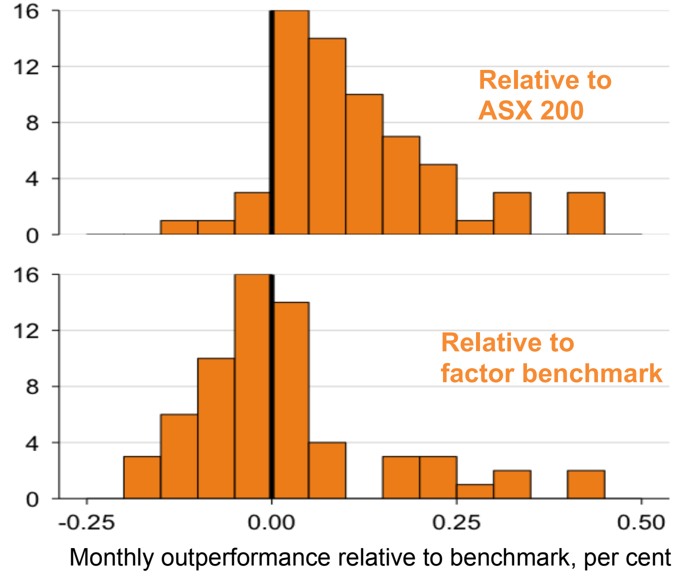
There are two possible explanations. First, they may be taking additional risks that pay off in some circumstances. That may or may not be a good strategy for the long run. Second, they may be taking advantage of lasting and systematic opportunities. If foreign or small investors make systematic mistakes such as selling excessively when the market is falling, then institutional managers can exploit them with some reliability over the long run.

In either case, finding such opportunities can cost less than the 'fully active' management style of building a portfolio based on detailed assessment of individual firms. Figure 14 indicates the savings that may be achievable through buying such less active investment styles. Superannuation funds typically pay active equity managers from 0.2 to 0.6 per cent a year in fees, with larger sums being managed for lower fees. Partially passive approaches, such as the rule-based approaches we used in constructing the individual benchmarks, may cost funds 0.1 to 0.2 per cent. Fully passive products that track the market index can cost superannuation below 0.05 per cent a year.

Overall, the analysis suggests that at least some of what is currently interpreted as skill in Australian equities management may be the result of factor exposures that could be achieved at lower cost than what superannuation funds pay today.

Figure 13: Australian equities managers do not outperform the market after adjusting for factor exposures

Count of managers, Jan 2004 – Oct 2014

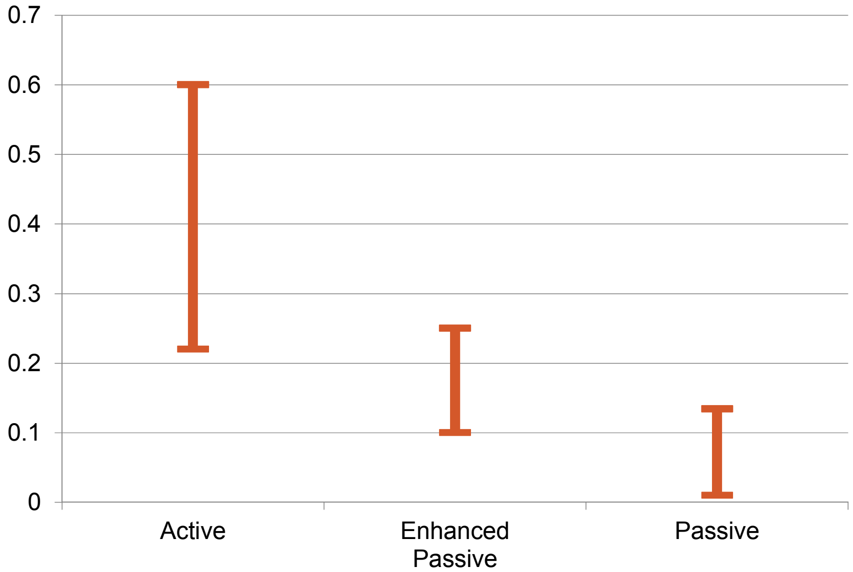


Notes: Factor benchmarks are created using the methodology outlined in Carhart (1997).
Sources: Grattan Analysis of manager strategies available in Morningstar's Separate Account/CIT database and equities from their equities database.

The exercise does not demonstrate that such rule-based approaches would produce good returns after real-world transaction costs and tax, though one Australian study asserts that momentum trading would be profitable with real-world information lags and transaction costs.[53] US funds aimed at momentum trading charge fees around 0.15 per cent per year.

[53]Bettman, *et al.* (2009).

Figure 14: Investment management fees for Australian equities are lower for more passive approaches
Per cent of funds under management per year, excluding performance fees



Notes: Upper limits are typical investment fees for small mandates; lower limits are typical for large mandates.
Source: AIST (2010).

Such partially passive investment styles also do not apply to unlisted assets and may not even apply to small-cap equities managers. Over the past decade, Australian small-cap managers outperformed the S&P Australian small-cap index by 4 to 10 per cent a year.[54] After controlling for managers' exposures to factors in the way shown in Figure 13, the average small-cap manager outperformed by about 3 per cent a year. But such managers do not provide the opportunity to invest very large sums: stocks outside the ASX 100 comprise only about 11 per cent of the ASX market capitalisation, and stocks outside the top 200 only 4 per cent.[55]

3.4 Few asset managers outperform for long

Evidence on how much value investment managers create can also be sought by comparing managers' performance against their peers. Within most asset classes, few investment managers consistently outperform their peers, displaying skill that would warrant paying them more than funds that may have performed less well previously.

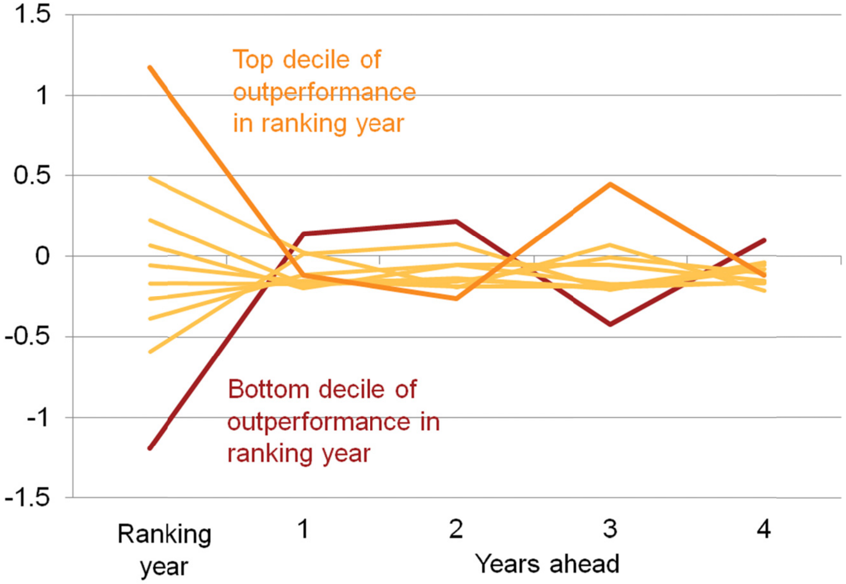
Figure 15 displays the performance over time of Australian equities managers, assembled into 10 groups by their performance in a given year. The figure shows there is little persistence in rankings across years. The top-performing ten per cent of managers beat the median by over 1 per cent per month in the first year. But in following years their performance is about average. Similarly, the bottom 10 per cent of managers underperformed by over one percentage point per month in the first year. In following years, their performance, too, is about average. The performance of the top and bottom group remains more volatile than that of the middle groups. Much of their initial deviation from the market seems to stem from taking risks that the rest of the market is not taking.

[54] AMP (2014) analyses small caps for the 10 years to March, 2014.

[55] Industry liaison suggests following other rules such as tracking stock sales by company directors can help to replicate small-cap outperformance.

Figure 15: Observed outperformance among Australian equities managers does not persist

Per cent monthly relative performance, 2004-2013



Notes: In each year from 2004 through to 2013, the annual returns of all Australian equities managers in Morningstar's Separate Accounts/CIT database are compared to the mean of the group. For all years from 2004 to 2009, funds are split into deciles based on their outperformance. The average outperformance of each decile is calculated for the next four nears. Results are averaged over all runs from 2004 to 2009.

Sources: Grattan analysis of all Australian Equity managers in Morningstar's Separate Accounts/CIT database.

The few managers in listed asset classes who do outperform their peers over successive periods before fees are difficult to identify in advance. By the time an investment star is recognized for its high performance, it is usually already fading back to the average.

Persistence in asset manager performance may not be primarily due to skill

Other studies suggest that asset managers who perform well have a slight tendency to continue to do so in the future. But persistence in performance does not appear to be sufficient to help select high-performing managers in advance.

Carhart (1997) shows that persistence in returns is largely because of persistence in the returns of underlying assets. Brown and Goetzmann (1995) find that persistence in risk-adjusted returns is correlated across funds, suggesting that persistence is probably due to managers following similar strategies.

Bollen and Busse (2005) find there is more performance persistence among wholesale asset managers than among mutual fund managers offering accounts to the public. But high-performing wholesale managers attract higher in-flows, and their relative performance tends to fall once this happens.

Jenkinson *et al.* (2014) show that the median asset consultant—whose role includes selecting asset managers—recommends low-performing equities managers as frequently as high-performing managers.

The findings call into question how many high performing managers have genuine skill.[56] It also suggests that superannuation funds may have little basis on which to identify managers that will go on to perform strongly in future. It may be

[56] The analysis cannot identify valuable trading strategies such as strategies that underperform in most years but have large outperformance occasionally.

argued that funds examine team quality and investment style as well as past performance in selecting managers. But such considerations may be no more helpful than past performance in selecting asset managers.

3.5 Summary of potential investment savings

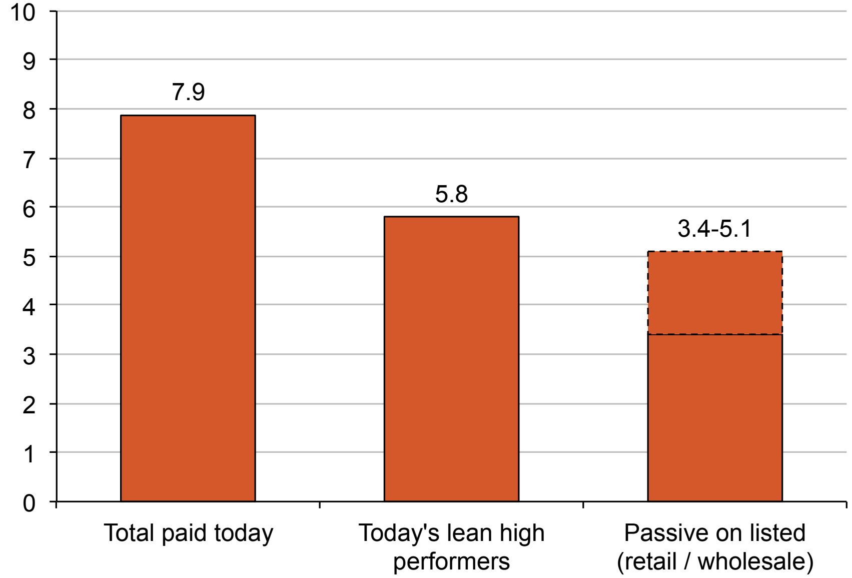
Across the system, there would be large savings if fees could approach those of current lean high performing funds. Figure 16 sets out the corresponding system costs. If the whole industry charged the 0.45 per cent per year of today's lean higher performers, rather than the average 0.6 charged today, savings would amount to about $2.1 billion a year, more than a quarter of all investment management fees, with no change in asset allocation.

Savings would still be large if restricted to default products only. If MySuper products were charged the lean funds' 0.45 per cent rather than today's 0.64 per cent average, savings would amount to about $800 million a year.[57]

Further savings could result from the more extensive use of passive or partially passive approaches in some listed asset classes. However, given the provisional nature of the evidence in favour of partially passive approaches, in our analysis of potential policy savings, no shift further towards passive products is assumed.

Figure 16: If the whole system had the costs of leaner funds, total costs would be $2 billion lower

Investment management fees, $ billion



Notes: "Today's strong performers" is 45 basis points, per Figure 13.
Sources: Grattan analysis of sources cited in Section 3.2. Passive fees from AIST (2010).

[57] Even reducing above-average MySuper product investment fees to the current average would save hundreds of millions of dollars.

4. Why average superannuation fees are high

Average superannuation fees are higher than they need to be for one main reason. Much of the system relies primarily on account-holders and employers to select the best products, but many do not. Some account holders do pay attention to fees, but because they tend to buy different products, such as those designed for people with large accounts, they put relatively little fee pressure on average fees.

There are many low-cost products and funds, as earlier chapters in this report document, often reflecting the lower costs of serving relatively large contracts, and the influence of more sophisticated buyers.

The higher costs and fees in much of the rest of the market reflect the costs of selling to a more fragmented and less sophisticated clientele. In this part of the market, funds do not compete primarily on fees. Instead, many compete on the basis of marketing campaigns, sales and distribution networks, member engagement services and on the breadth of their product ranges and investment options. All these forms of non-fee competition cost money, which is passed on as fees. They may do little to help account holders to understand what drives their long-run returns. The system remains inefficient and opaque, even as high fees erode account holders' net returns. The lack of fee pressure also allows other inefficiencies to persist.

4.1 Many account holders are disengaged

Many Australians are not well informed about their superannuation or the fees they pay. Many do not actively select their fund, and very few switch funds except when they switch jobs. Many others who are more actively engaged in superannuation make poor decisions because they focus on measures other than fees.

Figure 17 summarises the findings of three surveys of what people know about their superannuation and how involved they are. About half of account holders do not know the fees they pay. Three-quarters do not know their investment returns.

A minority of people choose their own fund. A survey commissioned for the Australian Tax Office found that 69 per cent of people did not choose their own fund when they joined their most recent employer. [58] Similarly, an Australian Bureau of Statistics study found that 70 per cent of individuals have their primary superannuation with an employer-nominated fund. Of these, about two-thirds play no role in selecting their fund or product.[59] Other studies put the proportion of employees who play no role in selecting a superannuation fund at 80 per cent.[60]

[58] Colmar Brunton (2010c).
[59] ABS (2009).
[60] See sources cited in Commonwealth of Australia (2010c), Endnote 4, p 36. Some of these studies appear to assume that being in a default product entails not having exercised any choice.

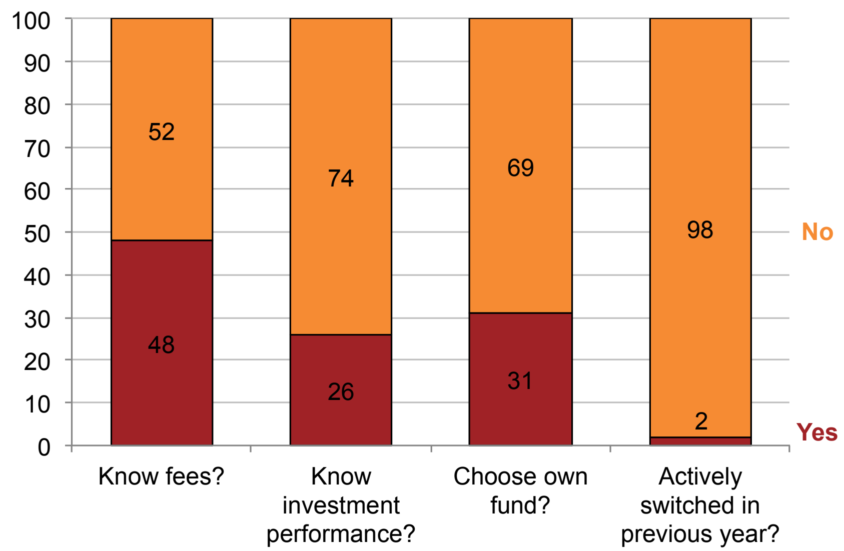
Finally, very few people — about two per cent of Australians with a superannuation account, at most — switched funds in 2013 for reasons other than switching jobs or their employer switching default funds.[61]

Of those who actively choose a fund, many say they seek to minimise fees. When asked what mattered in their choice of superannuation funds, 68 per cent said low fees and 62 per cent said high or strong investment returns.[62] Nevertheless, the surveys show that in reality very few know, compare, or act on the fees they pay.

There is also a wide array of evidence that many account holders under-value the importance of fees and do not respond much to fees. As one recent study puts it, "underweighting of fees is pervasive and sticky, robust to demographic variation and investor experience."[63] Unresponsiveness to fees is commonly found in studies of Australian and other account holders.[64] There may be several reasons why. Individuals may find it hard to compare superannuation funds because they do not understand the financial basics that are needed to make a wise choice of fund.[65] They may also defer decisions that affect their future wellbeing.

Figure 17: Few account holders are well-informed and fewer actively switch funds

Survey findings on superannuation account holders' knowledge and action on their accounts, per cent of respondents



Source: Q1: Financial Services Council and ING Direct (2013), Q2-3:Colmar Brunton (2010c), Q4: Colmar Brunton (2010c), Commonwealth of Australia (2010a).

[61] 3-9 per cent (Colmar Brunton (2010c), Roy Morgan (2013)) switch superannuation funds in each year. Around 80 per cent of them switch funds because they change jobs or their employers change funds providers (Commonwealth of Australia (2010a)).

[62] Colmar Brunton (2010c).

[63] Fisch and Wilkinson-Ryan (2013).

[64] Langford, *et al.* (2006), Choi, *et al.* (2010); references cited on p.4 and p.5 of Calderón-Colín, *et al.* (2008).

[65] Worthington (2008), Agarwal, *et al.* (2009); Capuano and Ramsay (2011); Lusardi and Mitchell (2011); Fisch and Wilkinson-Ryan (2013); Bateman, *et al.* (2014) .

4.2 Many employers are disengaged

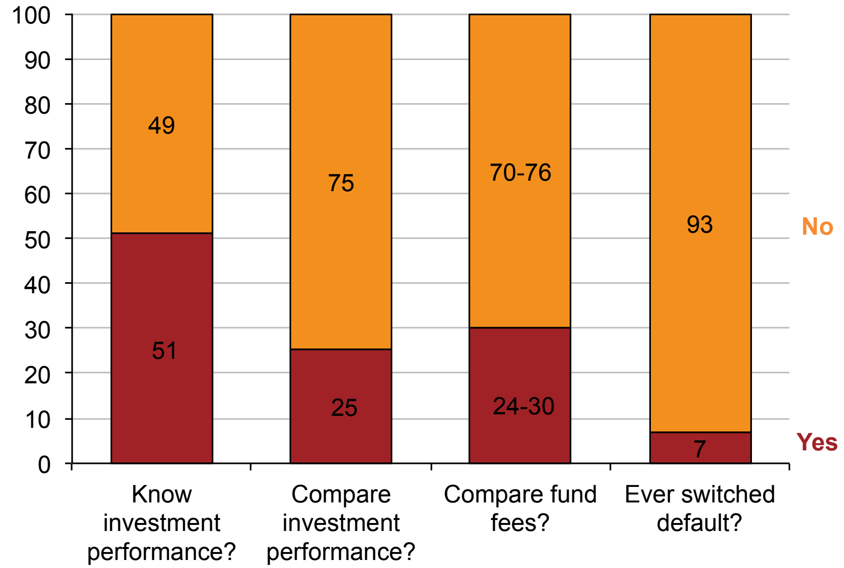
Employers play an important role in selecting default funds. Many of them are no more engaged or informed about superannuation than are their employees. Some may select funds that offer a broad range of options at high cost to employees. Some may consider their own costs and benefits before benefits for their staff.

Many employers are poorly informed about the performance and fees of the default funds they have selected on behalf of their employees. In a survey commissioned by the Australian Tax Office, 49 per cent of employers reported very little or no knowledge of their default fund's investment performance over the last year (Figure 18). Only 25 per cent said they had compared the investment performance of the employer-nominated default fund, and about 30 per cent said they had compared the fees with those of other funds.

Of all employers interviewed, only seven per cent had ever switched their default fund. These are likely to be the larger employers, so coverage of employees by employers who have switched must be much larger than seven per cent. Discounts achieved by large employers can exceed 50 per cent, indicating the potential for more widespread use of the procurement models used by sophisticated employers.

Figure 18: Few employers are well informed or active in selecting default funds

Employer knowledge of and action on the funds they nominate for employees, per cent of respondents



Source: Colmar Brunton (2010a).

Employers may also be motivated to select a superannuation provider that offers a wide range of investment options to their employees, even though products with many investment options typically charge high fees.[66]

Some employers may also select providers for reasons other than the best interests of their employees. Eleven per cent of large employers and four per cent of smaller ones report that the funds they chose had offered them incentives.[67] While incentives in the form of lower superannuation fees are in the interests of employees, some employers also said they had received offers of discounts on non-superannuation financial products such as credit cards and home loans.[68] The head of one bank-owned fund has noted that it is convenient for companies to have various services supplied by the one bank because "it makes relationship management seamless".[69] While efficient banking and superannuation relationships are a good thing, employers may in some instances pay more attention to their overall banking relationship than to the value-for-money of the superannuation fund that comes with that relationship.

4.3 Pressure from engaged customers has not cut fees much for others

Superannuation is simple in principle. It should offer exposure to assets that provide a good basis for accumulation of funds as the account holder nears retirement. Yet superannuation has come to be sold as a broad range of superficially differentiated products. There are hundreds of funds, most offering multiple products that are sold directly to customers – via telephone or the web, for example – or via distribution networks such as bank branches and financial advisers. Some funds offer few investment options, others many. Funds charge fees in diverse ways, including fees upon entry and exit, and ongoing annual fees charged as flat dollar amounts and as a percentage of account value. They offer different online and other service options.

Such broad choice can benefit active and engaged account holders, and indeed, some look for and find lower superannuation fees. Others — typically those with larger balances — may find it beneficial to set up a self-managed fund. Some large firms may negotiate discounts, while workers in the public sector or in some industry funds also pay low fees.

But such product and price dispersion also separates more sophisticated and fee-sensitive customers from the many who are disengaged. Disengaged customers get little, if any, benefit from pressure exerted by fee-sensitive shoppers. Those who have smaller balances, or whose employers choose a high-fee fund, or who simply do not appreciate the importance of fees can end up paying fees that are far too high.

[66] Rainmaker Information (2013), p. 8.
[67] 'Large' companies are those with more than 100 staff.
[68] Colmar Brunton (2010a).
[69] Patten (2014).

4.4 Inattention to fees has permitted costs to grow largely unchecked

The inattention of many account holders to fees has driven providers to seek to differentiate themselves with a range of diverse products and services. They have developed sales and distribution activities to capture and protect profitable market share. They have developed a range of product and service features such as platforms that provide a broad range of investment options.

All these features drive up costs and fees. Competition on these features, rather than on fees, does not remove other inefficiencies such as excess pay, manual processes or overly active management of funds that further reduce net returns.

Funds bear the costs of distribution, sales, marketing and product differentiation.[70] These costs make sense for each fund but they hurt the net returns of investors. Funds report that marketing and distribution costs are about 7 per cent of total costs, though some commission costs appear to be omitted from APRA reporting.[71]

But the full costs of product differentiation and member engagement must be much higher than the reported cost of marketing and distribution alone. They would include many of the capital and operational costs of engaging members, creating product ranges and providing a choice platform that allows consumers to make decisions about where their money is invested. These costs are not reported separately but constitute a large fraction of the non-investment costs of super funds.

Some funds incur other costs that further reduce net returns. Some retail trustees use related-party administrators and pay higher fees.[72] In some cases, there is evidence that fee negotiations do not extract reasonably expected value from external asset managers.[73]

As a result of all these factors, non-fee competition over the last decade has largely absorbed benefits from improvements in technology and scale.

[70] Williams (2014).
[71] Arnold (2012).
[72] Liu and Arnold (2010).
[73] Sy and Liu (2010).

5. Recent policy initiatives will not cut fees much

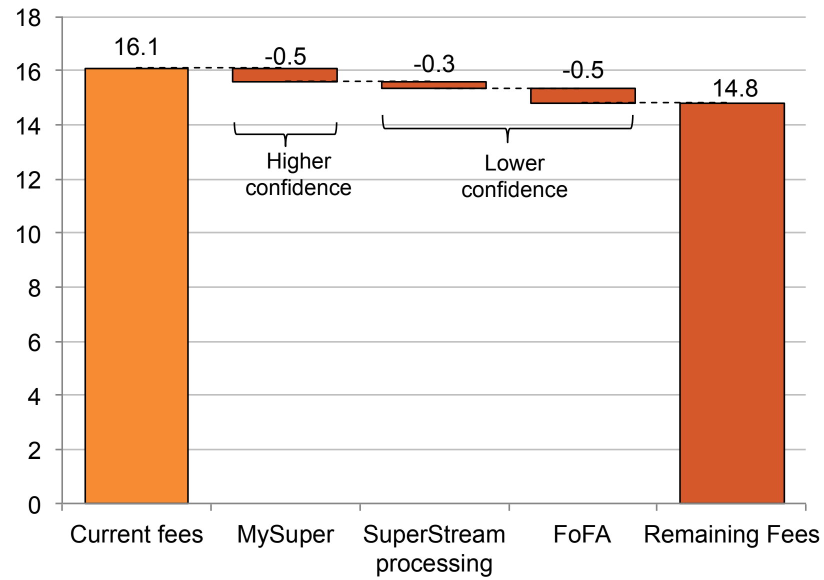
Chapters two and three reveal the large gap between current and achievable costs in superannuation. The policy changes governments have made in recent years go in the right direction, and together are likely to save over a billion dollars a year, as Figure 19 shows.[74] They also provide a platform for further initiatives that can produce substantial savings.

At present the total bill for running superannuation is about 1.2 per cent of funds under management a year, or $16 billion across the collective funds, plus about $5 billion in self-managed super.

The Stronger Super reforms, to be phased in by 2017, seek to simplify default products, reduce administrative costs, improve governance of superannuation funds, and improve confidence in the self-managed superannuation sector. The two key elements of the reforms, SuperStream and MySuper, may reduce annual costs and fees by about $800 million below business as usual in the next few years. Most of these savings will be realised in the default segment.

The Future of Financial Advice (FoFA) reforms, introduced in 2012 to protect investors who receive financial advice, may reduce fees on choice products over time. The savings will take time to be realised, as the reforms only restrict commissions on newly sold products. FoFA savings will accrue in the choice market as a reduction in commissions.

Figure 19: Recent initiatives will save over a billion dollars
$ billion fees and potential savings



Notes: Collective funds only (excludes SMSFs).
Sources: Savings set out in sections (5.1-5.3).

[74] See Appendix 1 for a table summarising baseline fees and initiative impacts.

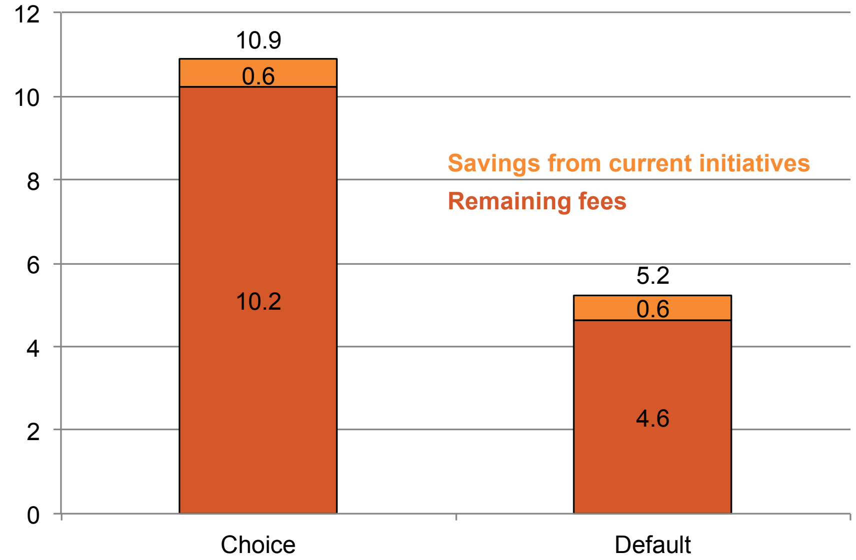
New, more explicit trustee obligations may sharpen trustees' focus on costs. Yet funds have long been obliged to act in members' interests, so it is unclear whether more explicit obligations will make much difference. The new MySuper scale test may spur smaller funds to merge with more efficient ones if trustees determine account holders are disadvantaged by their fund's scale.

Recent initiatives to consolidate accounts have slowed the upward trend in accounts per person. They provide a platform for further savings of about $360 million, but these are unlikely to be captured without new steps to slow the creation of excess accounts that occurs when people switch jobs.

Figure 20 summarises the impacts that the major recent initiatives are likely to have on the default and choice parts of the market. Together, they could save about $600 million in the default segment and about $700 million in the choice segment. MySuper will save $500 million in defaults. FoFA savings, which may be about $600 million, will be realised in the choice market. SuperStream processing cost reductions will save a total of about $300 million across both segments.

The rest of this chapter details the extent of savings that are likely to result from recent changes to superannuation policy.

Figure 20: Recent initiatives offer savings in both the choice and default segments
$ billion fees



Notes: Collective funds only (excludes SMSFs).
Sources: Savings set out in sections (5.1-5.3).

5.1 MySuper may save about $500 million

From January 2014, all default products must be an authorised MySuper product, which means they must meet standards designed to make them easier to assess and compare.

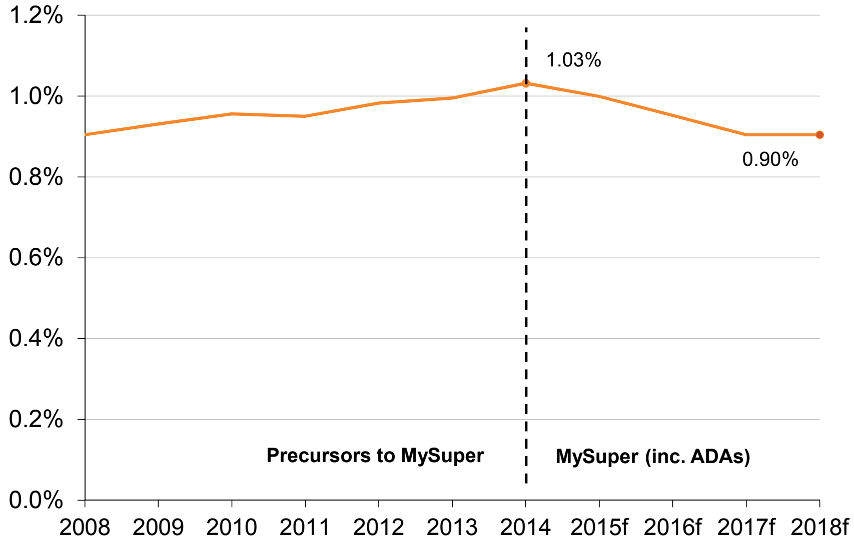
Average default fees on a $50,000 account, including discounts negotiated by employers, will fall to about 0.9 per cent a year by 2017, when all remaining accrued default amounts must be transferred into MySuper products (Figure 21). The change is likely to reduce fees paid by default account holders by about $500 million a year.

The fall in projected average default fees is due to the reduction in retail funds' default fees when they introduced MySuper products. They remain the most expensive default funds on average (Figure 22).

These projected savings may not fully materialise. Not all the $72 billion of member accounts currently in higher-fee pre-MySuper products (so-called 'accrued default amounts') will be transferred into MySuper products. One large retail fund disclosed to us that it has contacted members asking if they would like to stay on their existing default products rather than be transferred to a MySuper product. It reported that about half of the members contacted have agreed to stay.

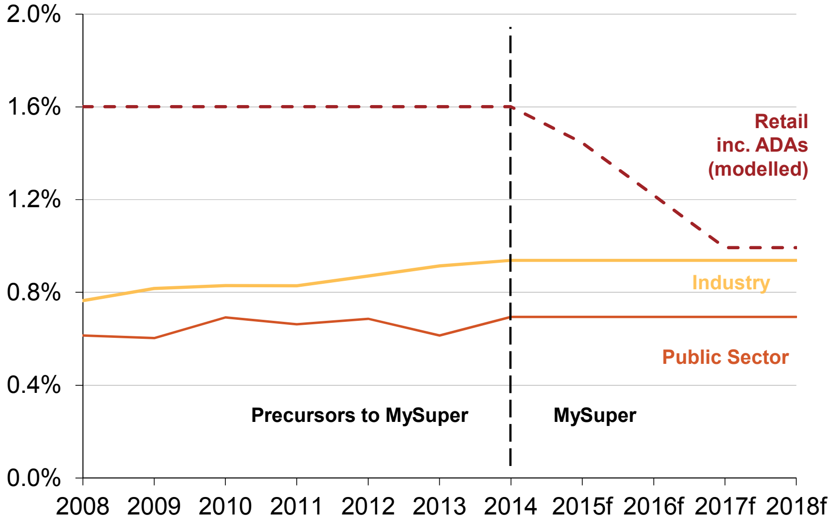
Figure 21: Default fees may fall by about 10 per cent due to MySuper

Fees (per cent) on a $50,000 default account



Notes: Assumes the $73b of Accrued Default Amounts (ADAs) are held by retail funds and will be rolled into retail MySuper products over the period Jul 2014-July 2017. Assumes no change in market shares (Industry - 55%, Retail - 21%, Public Sector - 20%, Corporate - 4%). Assumes retail products have weighted average discounts of 0.12% off their list fee. Assumes that default fees pre-MySuper were 1.6% on a $50,000 balance.
Sources: Minifie et al. (2014), p .22 and Grattan analysis of APRA (2014m).

Figure 22: The reduction in fees is driven by a reduction in retail default fees
Fees (per cent) on a $50,000 account

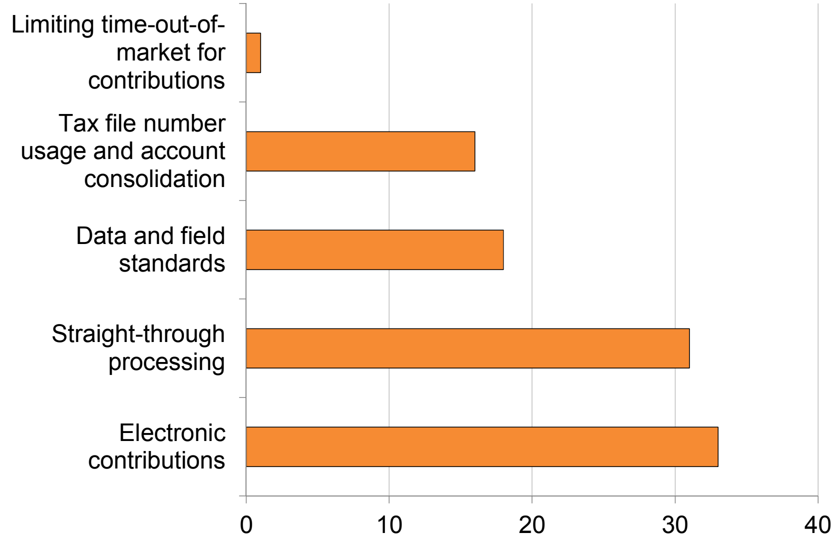


Notes: Assumes the $73b of Accrued Default Amounts are held by retail funds and are rolled into their respective MySuper products over the period Jan 2015 to July 2017. Assumes no change in the fees charged by Industry and Public Sector funds on a $50k account. Assumes average discount of 0.12% off the list price of retail MySuper products. Assumes that default fees pre-MySuper were 1.6% on a $50,000 balance.
Sources: Minifie et al. (2014) and Grattan analysis of APRA (2014m).

5.2 SuperStream data standards could save about $300 million

New data standards being phased in under SuperStream will reduce the costs of paper-based processing of payments over time.

Figure 23: SuperStream could reduce processing costs by a third
Per cent operating cost savings funds expect from SuperStream



Sources: FSC and Ernst & Young (2010)

Superannuation executives estimate that SuperStream could cut processing costs by about 30 per cent, or $300 million a year

(Figure 23).[75] The improvements in data standards will also save time for employers and funds by simplifying contribution processing.

5.3 FoFA will help to reduce fees for choice superannuation products over the long run

The Future of Financial Advice (FoFA) reforms, which passed into law in 2013, are intended to reduce, over time, any commissions paid unknowingly from superannuation accounts to advisers. They are also intended to improve the quality of financial advice. Government relaxed some aspects of the reforms by regulation in 2013, but the original reforms have been reinstated.

How FoFA might change superannuation fees is unknown. Financial advisers in the choice, APRA-regulated part of the superannuation market are estimated to earn from $1.4-$2 billion a year in total.[76] One study projects that over time, FoFA could reduce the income of advisers from superannuation by about 25 per cent, saving about $350-$500 million, or about 0.04-0.06 percentage points a year in fees charged in the choice part of the market.[77]

Box: The Future of Financial Advice reforms

The FoFA reforms seek to ensure that financial advisers act in the interests of their clients. Their four main elements are:

The client interest test. Financial advisors must act in the best interests of clients. In recommending a financial product, the adviser must establish that it is appropriate to the client's needs.

A ban on conflicted remuneration. All monetary or non-monetary benefits that product providers pay to the financial adviser are considered conflicted remuneration and are banned, including 'volume based incentives' and shelf space fees. Remuneration must instead be in the form of a fee for a specific instance of service, or an 'ongoing fee arrangement' the client pays to the adviser. The ban affect products sold after July 2013.

Fee disclosure. Advisers are required to provide clients with a statement of "ongoing fee arrangements" every 12 months. The requirement is intended to assist the consumer in assessing whether they are receiving adequate service for their money. Advisers do not need to disclose commission revenue derived from products sold before July 2013.

Opt-in for ongoing fees. Advisers who charge fees for ongoing advice must receive written confirmation from their clients every two years. The requirement is intended to give clients a regular opportunity to re-evaluate the value for money provided by their financial advisers. Advisers do not need to ask clients to opt-in to paying commission revenue derived from products sold before July 2013.

[75] Evidence on the total cost of contribution processing is sparse. Benchmarking studies of larger, lower-cost funds suggest that payment processing in total costs about $20 per account, which would imply about $600m - $800m in total including higher costs for some funds (ASFA (2014)). SuperChoice (2009) makes a higher estimate for contribution processing of $1.25b. An estimate of $1 billion for processing costs appears reasonable. It implies costs of about $30 for each of 30 million accounts in total, or about $70 per active account.
[76] Rice Warner and Industry Super Australia (2013); Rice Warner (2014).
[77] Rice Warner and Industry Super Australia (2013).

A shift from commissions to direct fee for service, which some industry experts say is happening, is likely to lead to a reduction in headline superannuation fees.[78]

It is difficult to predict when benefits from FoFA may be realised. Because FoFA does not impose restrictions or disclosure requirements on existing commissions paid on products sold before July 2013, it may take many years for FoFA to change the fees most people actually pay. Advisers should interpret their obligation to act in the best interests of their clients as requiring them to move their clients out of higher-cost products even if it reduces their own incomes. However many may not take this view given the explicit grandfathering of disclosure and commissions on products sold before mid-2013.

5.4 Savings from account consolidation will require further policy initiatives

With 12 million excess superannuation accounts in the system and each costing funds about $30 a year to service, excess administration costs are approximately $360 million a year (Chapter 2). Government has taken steps to encourage people to consolidate their accounts but has not yet slowed the creation of unnecessary new ones.

Recent government initiatives have reduced the number of excess accounts. Superannuation funds are now required to consolidate multiple accounts belonging to a single account holder within a fund. The ATO has linked millions of accounts to tax file numbers, and the Government's myGov website makes it easier for account holders to view and consolidate their accounts. The ATO has also been empowered to take control of lost accounts with balances of less than $2000 that have not received contributions for 12 months. Once managed by the ATO, accounts no longer incur fees, but only receive a guaranteed return equal to inflation.

These initiatives have reduced account numbers. Funds have taken steps to consolidate the accounts they hold, though how many is not publicly known. Many account holders are using the superannuation platform on myGov. In the first half of 2014-15, 265,000 accounts were consolidated. In addition, the ATO has been sent over about a million unclaimed superannuation accounts in the last year, in accordance with the Unclaimed Superannuation Money legislation.

Nevertheless, not enough has been done to stop the creation of new unwanted accounts. In 2012-13, 2.3 million new employer-sponsored accounts were created.[79] Without new initiatives, the number of accounts per person may not fall much further, and could even start rising again.

5.5 Extensive fund consolidation may require further policy initiatives

If many funds were to merge, superannuation administration costs could fall by $500 million or more a year (Chapter 2). But such savings seem unlikely under current policy settings.

Public-offer funds have consolidated steadily over the past decade. But this consolidation has not saved a lot of money.

[78] O'Donoghue (2014).

[79] APRA (2014a).

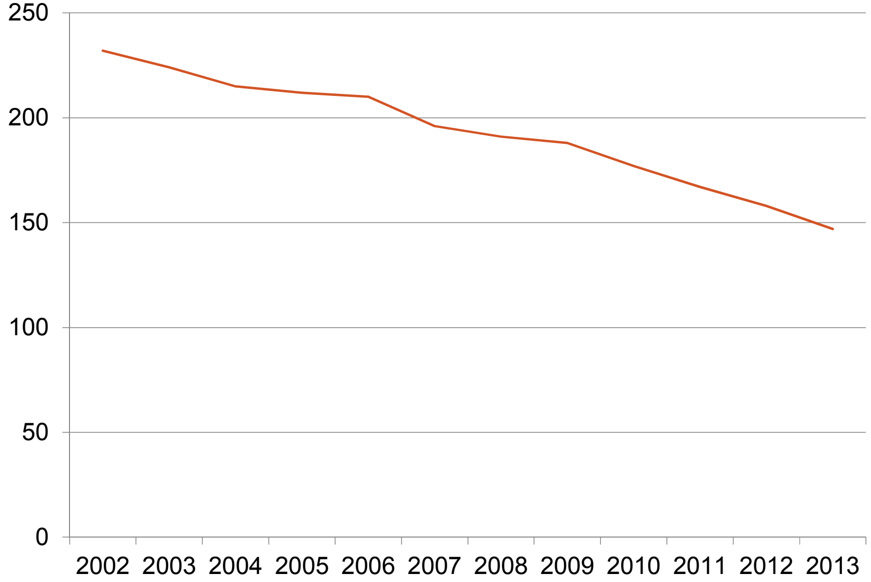
While the number of funds has fallen by about 10 a year (Figure 24), typically it is smaller funds – not inefficient medium and larger-sized funds – that close.

Fund consolidation may be impeded by current rules that restrict the movement of accounts from one product to another. The rules dictate that an account can only be moved to a new product if it is judged to be equivalent to the existing one.[80] Submissions to the Financial System Inquiry argue that the test can be overly strict and can impede fund mergers by making it impossible to cut costs by fully closing old products. They recommend that accounts be moved if the new product leaves account holders at no overall disadvantage, a less stringent test than the existing one.

A round of fund mergers is possible in the next few years. Funds may have delayed mergers while they made the changes to their businesses required by Stronger Super. They may also be able to merge more easily after SuperStream comes into operation. The recently announced merger of two large external administrators – which are private firms that funds outsource administration to – may also reduce barriers to fund mergers.[81] Though, in the past many higher-cost funds that shared administration platforms have elected not to merge. The new MySuper scale test may also provide some impetus for funds to merge, as discussed below.

Figure 24: About ten public-offer funds have consolidated each year

Number of public-offer funds (excluding corporate funds)



Notes: Public-offer funds excluding corporate products (as determined by APRA). Only includes funds with assets above $50 million.
Sources: APRA (2014a).

Overall, it seems unlikely that fund consolidation will lead to lower fees soon unless competition based on net returns and its major long-term drivers – gross investment performance and costs – is markedly strengthened.

[80] Superannuation Industry (Supervision) Act 1993 (Cth).
[81] SuperPartners is expected to be purchased by Australian Administration Services.

5.6 New trustee obligations may not change fund behaviour much

Legislative amendments imposing more explicit obligations on superannuation funds and their boards came into force on 1 July 2013. Yet, unless the regulator interprets them strictly, the new obligations may not make much difference to fund efficiency.

For many years superannuation funds have been obliged to act in the best interests of their members. Trustees have long had obligations to fund members under a range of instruments: the Corporations Act, the common law of equities and trusts, the Superannuation Industry (Supervision) Act and prudential standards on governance, conflicts, fitness, and insurance, among others, that have equivalent force at law to an Act.

The amendments do make the duties of superannuation funds and the personal liability of individual trustees more explicit.[82] In addition, funds offering MySuper products have assumed new duties and responsibilities. Perhaps the most important new duty is the "scale test": fund trustees must undertake a yearly process to review whether their MySuper members are not disadvantaged due to the scale of the product or fund.

Trustees may be beginning to invest more in their skills and education in order to meet the new more explicit and personal obligations. Yet only cautious optimism is justified: the long-standing obligation to act in the best interest of members has not yet managed to remove many underperforming products.

Whether consolidation hastens may depend on how strongly APRA applies the MySuper scale test.[83] Unless APRA applies the test aggressively, the new trustee obligations appear unlikely to result in more than a few mergers.

5.7 Individual cost savings do not necessarily result in aggregate cost savings

Reductions in individual administration cost items may fail to reduce total costs or account holder fees. This has happened before. Despite the large rise in the size of the average fund between 2005 and 2013, a change that should have achieved savings for members, administration expenses rose from $125 to $200 per account in 2013 dollars[84]

Looking ahead, fund executives say they expect their operating costs to rise in the next few years (Figure 25), suggesting that fees will not fall much unless profits decrease. And savings may be offset by cost increases as funds incur marketing, member engagement, sales and other costs in competing for members.

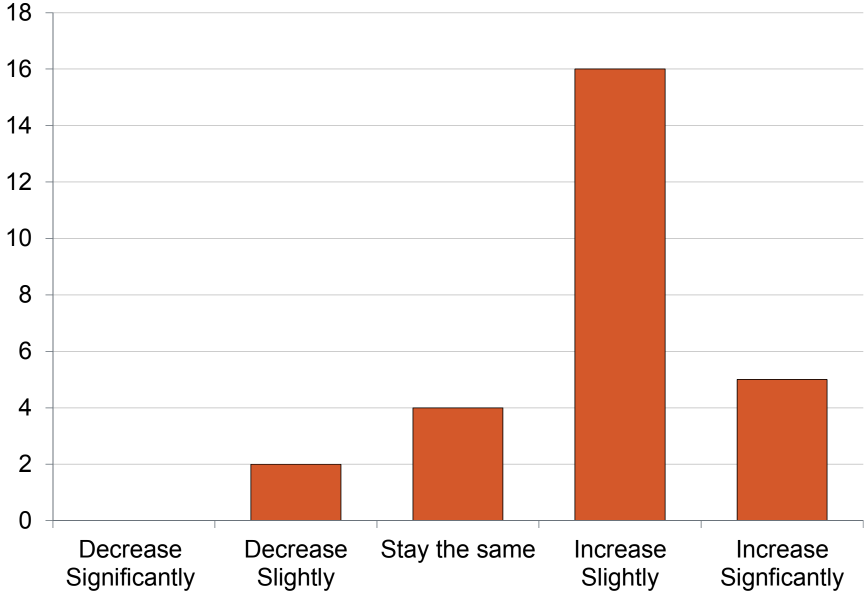
[82] New covenants on risk management, insurance and investments must be read into each trust. The trustee now must put the member's interest first where there is a conflict between duties the member and anyone else. There is also a new prudential statement on Governance covering board composition, mandatory terms, and mandating the preparation and execution of a board renewal policy. The pre-existing requirement that trustees be fit and proper also now requires that the trustees have appropriate skills.

[83] Superannuation trustees must demonstrate that their MySuper members are not disadvantaged vs the account holders of MySuper products offered by other funds, especially on the basis of scale.

[84] APRA (2014i) 'Operating expenses' as reported to APRA.

Figure 25: Superannuation fund executives say they expect operating costs to increase

Number responding - How do you anticipate that your operating costs will change in 3 years'?



Notes: Executives answered the question: "How do you anticipate that your operating costs will change in 3 years' (i.e. after Stronger Super Implementation)?"
Sources: ASFA and PWC (2013).

5.8 Conclusion: recent policy initiatives are likely to reduce fees by less than 10 per cent

The policy initiatives introduced over the last five years have been positive for superannuation efficiency. But Australian costs remain far above the costs achieved by defined-contribution systems overseas that have centralised administration, or that have used competitive mechanisms such as tenders to drive down costs.

Current policy initiatives seem likely to cut costs by more than $500 million, and perhaps as much as $1.4 billion, a year. MySuper and SuperStream settings could save about $800 million a year, or just over five per cent of total fees paid to collective funds. MySuper will save most of this, with a smaller contribution from SuperStream processing cost cuts. FoFA and new trustee obligations may deliver incremental benefits over the long term.

Initiatives that affect fund and account consolidation have set the stage for a further $1 billion in savings, but that will only be realised only if policymakers aggressively pursue them by reducing the creation of new surplus accounts, applying the MySuper scale test, and seeking to shift the basis of competition to costs and fees. These and other initiatives are discussed in the next chapter.

6. How to make superannuation more efficient

The previous chapter shows that current policy initiatives will remove some excess cost from the system, but much more can be done. To make default superannuation more efficient government should build on recent policy initiatives and act on the findings of the 2014 Financial System Inquiry (FSI).

Government should ensure that all parties in superannuation recognise the vital importance of an efficient system to the achievement of the system's prime objective: to provide for retirement incomes as a supplement or alternative to the age pension. Reform should have four main elements:

- Government should run a tender to select funds for default superannuation. Government should not wait years to run an efficiency review when the evidence is already strong that current policy settings leave billions on the table.
- Government should take steps to slow the creation of new excess accounts.
- It should encourage less efficient funds to merge with efficient ones.
- It should introduce measures to strongly encourage the selection of lower cost products in the choice part of the superannuation market.

6.1 Potential benefits of reforms

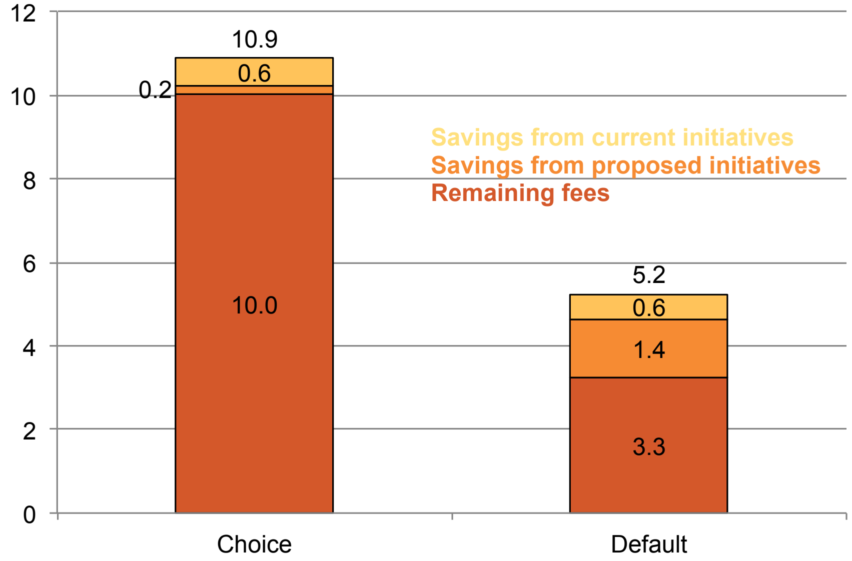
The first three initiatives could save more than $1.5 billion.[85]

- A competitive process for defaults could save over $1 billion a year. Government should design the tender now and run it as soon as possible.
- New steps to remove excess accounts could save $360 million a year. It would not be a particularly complex initiative and would be a natural extension of work that has already been done to consolidate accounts.
- Steps to encourage less efficient funds in the choice segment to merge with efficient funds could save an extra $200 million a year or more.

These three initiatives will have more impact on reducing costs in default than in choice funds, as Figure 26 shows. The tender is a default initiative, and most account consolidation savings will benefit default account holders. Fund consolidation in the choice space may be limited by the relatively large size of the five biggest superannuation funds, while the many smaller industry superannuation funds could be consolidated in the default market.

[85] See Appendix 1 for a table summarising baseline fees and initiative impacts.

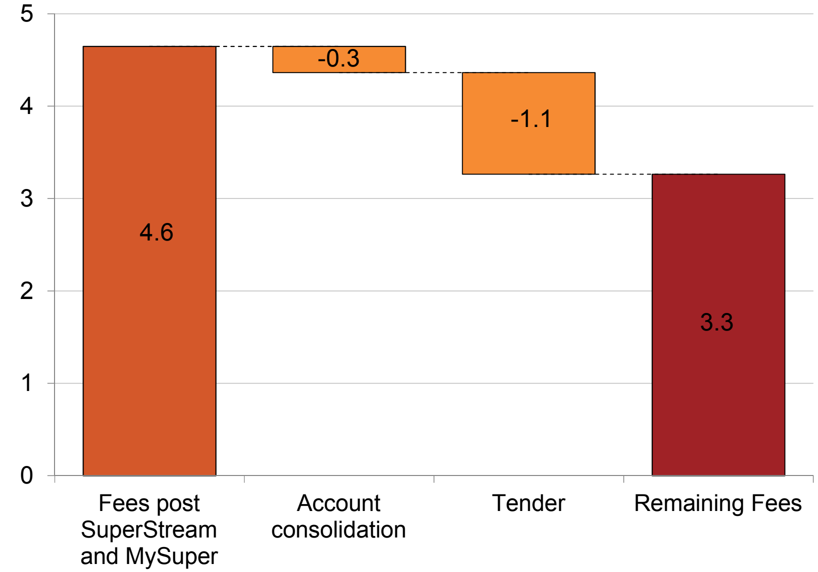
Figure 26: Proposed initiatives save more in defaults than in choice
$ billion fees and savings



Notes: Collective funds only (excludes SMSFs). Modelling assumes that cost reductions are directly passed on as fee reductions.
Sources: Savings from current initiatives are set out in Chapter 5; savings from proposed initiatives are set out elsewhere in this chapter.

The choice segment is likely to remain relatively expensive, to the cost of many account holders. The opportunity to save money by encouraging the selection of lower cost products in the choice parts of the market appears to be large, since the choice market is where the greatest excess costs appear to be. The size of the opportunity, though, is difficult to estimate.

Figure 27: Policy initiatives could reduce default fees by a quarter
$ billion fees and savings in default superannuation

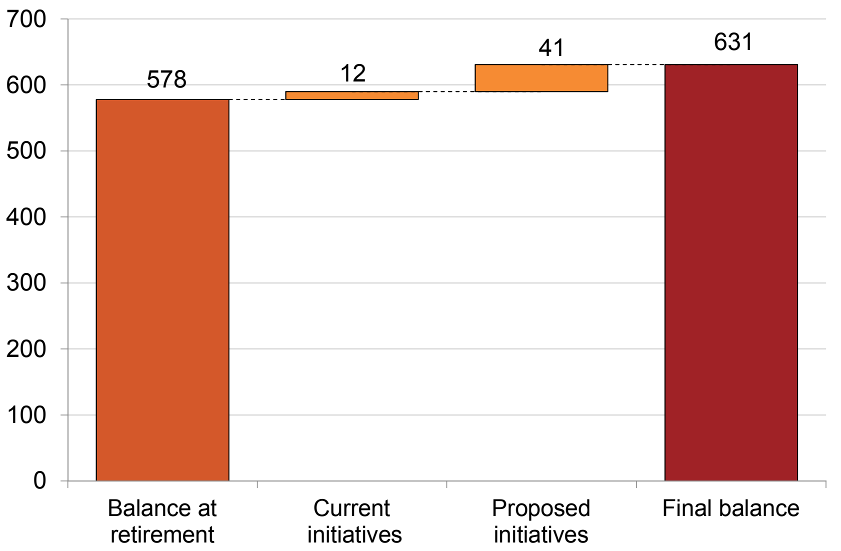


Notes: Modelling assumes that cost reductions are directly passed on as fee reductions. Does not include advice fees.
Sources: Grattan analysis.

A tender is likely to remove much of the remaining excess cost in defaults. Figure 27 shows that account consolidation and the tender (which includes benefits from fund consolidation prompted by the tender) could reduce total default fees by a quarter, from $4.6 billion per year to $3.3 billion per year. Average fees would fall from about 0.9 per cent per year (post MySuper and SuperStream) to about 0.65 per cent per year or lower.

As a result of these reforms, default account holders are likely to retire $40,000 wealthier on average. Even people who now have a single account are likely to save $34,000.

Figure 28: A typical default account holder could be $40,000 better off at retirement
$ thousands in superannuation balances at retirement per person



Notes: Assumes 40 years of contributions; 1.8 per cent real wage growth; 5 per cent real investment returns (net of tax); starting wage $45,000; contributions 10% of wage. The three modelled scenarios are balance at retirement under three different policy settings: pre-Stronger Super, post-Stronger Super, and post-tender and account consolidation (as recommended in this chapter). Each of these scenarios involves different fees and average account numbers per member: 0.85% & $75 fixed per account (pre-Stronger Super), 0.73% & $75 fixed per account (post-Stronger Super), and 0.45% and $112 fixed per account (post our recommended reforms). The number of accounts per person in each scenario is 1.85, 1.85 and 1.1 respectively. Source: Grattan analysis.

6.2 Run a competitive tender to select default funds

Government should design and run a tender that would select funds that could offer default products.

The FSI recommends that if a review undertaken between 2017 and 2020 finds that current policy settings leave an efficiency gap, government should introduce a "competitive process" for allocating new default account holders to superannuation products.[86] The FSI recommends that design of the tender begin this year, suggesting it expects that any review is likely to find continuing excess cost. If that is so, Government should act now to establish the tender, since delay merely costs more money.

6.2.1 Design of the tender

The tender would select a shortlist of default funds. It would need to be carefully designed and tested to ensure that the quality of assets in which funds are invested is maintained or improved, service levels are appropriate, and costs reduced. As the FSI emphasises, much work needs to be done to evaluate alternative models and finalise a preferred model for the competitive mechanism.

Government should consider a broad range of options for the competitive process. Overseas systems or funds provide a wealth of experience on how government can use competitive processes to cut superannuation costs. Many governments have successfully taken similar steps with their retirement systems, including Sweden's defined-contribution system, the United

[86] Financial System Inquiry (2014).

States' Thrift Savings Plan, New Zealand's Kiwisaver, and the Chile's default tender.

These systems, while not perfect, have typically produced default products that are typically cheaper than Australian defaults.[87]

In designing a competitive mechanism, government should also learn from the strengths and weaknesses of the process APRA uses to authorise MySuper products, and of the anticipated Fair Work Commission process for shortlisting default funds in awards.

Any tender process should give substantial weight to fees and costs. Grattan's 2014 *Super Sting* report proposes that the tender be a fee-based auction (Figure 29), since that would suit listed asset classes in which low-cost, less active investment styles are likely to perform better than other approaches over the long run.

For some other asset classes, fees remain important, but selection based purely on fees may not give investment managers sufficient incentive to perform.[88] These classes, which include unlisted infrastructure, property, private equity, and venture capital, comprise about 20 per cent of fund portfolios. Instead of a fee-based tender for these classes, government could give weight in its selection criteria to past performance net of fees, and to modelling of prospective future net returns. It could also restrict participation to funds that have substantial continuing businesses in those asset classes.

Figure 29: Elements of one tender design for default funds.

Default product	• Asset allocation range / ranges; diversification • Limits on trading volumes (churn, tax) • Insurance defined separately; fixed administration fee
Applicable flows	• Period: e.g. two years • Applicable accounts: e.g. all new default accounts
Auction design	• Open or closed bids; if open, number of rounds • If multiple asset classes, single / simultaneous rounds • Period over which winning fee remains as a cap • Separate competitive tender for insurance
Roles	• Pre-qualification by APRA, as today • Another government body to run the tender • If more than one winning fund, role for employers, FWA
Supporting changes	• Protections for legacy MySuper account holders • Limitations on 'upsell' of default account holders • Dashboards on legacy and choice products

Source: Grattan analysis.

Government will also need to ensure that winners are not the funds that best hide costs.[89] Expert advice on how to make products comparable will be required. Investment products can be difficult to compare, but it can be done, and governments, businesses and superannuation funds already do it satisfactorily.

Government would need to monitor the tender over time. Trustees of winning funds would retain their obligation to adjust their investment model and asset exposures to maximise risk-adjusted net returns for members, and would retain discretion to hire and

[87] Minifie, *et al.* (2014), Chapter 4.
[88] Heale (2014).
[89] Norvaca International (2014).

fire asset managers. They would need to seek approval for material departures from the terms on which they won the tender.[90]

Some may argue that any tender involves government too deeply in funds' decisions about how to allocate their members' assets. Yet continuing inefficiency in the sector must be addressed. Government is already deeply involved in superannuation, since it requires employers to contribute 9.5 per cent of wages and salaries on behalf of most Australian workers. It has a heavy responsibility to make super funds provide better value.

6.2.2 Potential savings from a tender

Defaults already cost less than choice products. But a tender still presents a substantial opportunity to further cut costs in defaults while preserving member services and asset allocation.

A tender would strongly shift the basis of competition towards net returns. Funds could cut expenditure on marketing and sales efforts, and on building platforms that few use to select from investment options that few require. A tender would strengthen funds' incentives to cut costs, including via mergers, since less efficient funds would lose share over time.

Funds that can offer fees of total 0.65 per cent a year or lower while preserving asset quality are likely to win the tender. That is significantly below today's average of 0.90 per cent for MySuper products. Savings on today's $465 billion of funds under management would therefore be at least $1.1 billion a year. There is a strong case to use the tender only for new accounts, so savings would phase in over time.[91]

Under a tender, administration costs could be expected to be $100 or less per account (Chapter 2), or 20 basis points on a $50,000 account.[92] Winning funds can be expected to set investment fees of about 0.45 per cent for an asset mix that includes exposures to unlisted assets similar to today's system (Chapter 3).

In *Super Sting*, we estimated that a tender could save up to $2.8 billion. Our new estimates are lower because

- Newly published APRA data shows there is $440 billion in default products rather than the $550 billion we estimated;
- Preserving today's asset allocation, which includes unlisted as well as listed products, adds about 0.2 per cent to investment costs.

Public sector funds and large corporate tenders (in which large employers tender out their superannuation requirement to funds) already attain costs of 0.65 per cent or lower. Savings could be greater if the fees for listed asset classes were to approach

[90] As time can be of the essence in some investment decisions, funds could retain full discretion but be required to seek such approval promptly afterwards.

[91] If all default accounts were transferred at once that would be highly disruptive to the industry and would violate the choice of account holders.

[92] These current and prospective fees reflect today's level of inactive accounts, which adds about 0.06 percentage points to admin costs per person but reduce fees per account by about 0.10-0.15 percentage points. After account consolidation, but otherwise at today's costs, default fees would be about 1.0 per cent per year.

today's wholesale fees for passive or rule-based investment styles.

The tender, along with other initiatives, is likely to encourage funds to merge, as over time it will reduce inflows to all but the most efficient funds.

6.3 Ensure any efficiency review focuses firstly on what affects net returns

The case for an immediate design and switch to a tender is strong. Yet if government decides to adopt the FSI's recommendation and wait to see whether policy changes improve efficiency substantially, it should prepare for an efficiency review now and run it soon. The review should focus above all on whether the system is generating strong net returns for all members. The box below shows criteria against which the system should be assessed.

What would an efficient super system look like?

In an efficient system, the vast majority of **default members** may be served by funds that charge no more than 0.65 per cent and probably below 0.5 per cent for administration and investment management combined. The vast majority of **choice members** should also be in lean funds.

Default members would be charged **administration** costs of well under $150 a person and perhaps below $100, regardless of account size. Fees should only be charged above that level if there is strong evidence of additional value to account holders.

Default members would be guaranteed that their balances were invested in a diverse way across asset classes that are appropriate to the account holder's age. **Investment costs** could be expected to be about 0.45 per cent of total funds invested, or less, with appropriate low-cost exposures well below 0.2 per cent in listed assets, and some exposure to unlisted assets at a likely cost of around one per cent, based on diversification and return benefits. These fee benchmarks would only be exceeded when supported by evidence of strong returns. Funds would report on tax, trade and execution costs and would appropriately balance such costs against benefits.

In an efficient market, investment products that charge higher investment fees would not have lower risk-adjusted net-returns.

Funds should be able to prove they have rigorously applied the "scale test", and acted promptly on their duty to ensure their MySuper members are not disadvantaged. They should also be able to show that they rigorously assess investment managers, with longer-term efficiency the main criterion in each asset class and appropriate diversification across asset classes or risk factors.

Across the system, an automated process would minimise the number of new surplus accounts generated. There would be strong consolidation into the most efficient fund models by greater fund consolidation or outsourcing of functions to the most efficient administrators. Members who make their own investment choices would not end up in products that provide lower net returns at higher risk.

6.4 Reduce the number of new accounts

Further steps to reduce the number of excess superannuation accounts could save about $30 per account – or $360 million a year, about six per cent of the administrative cost base.[93]

Government has already taken steps to make it easier to consolidate accounts. It now needs to stem the creation of excess accounts that occurs when people change jobs. It should ensure that existing superannuation account details are automatically accessed as part of the standard job induction process. Unless individuals explicitly choose to create a new account, they should remain with an existing account or consolidate existing accounts into the employer-chosen fund. Government should ensure that online systems suited to this process are implemented.[94]

The ATO holds 4.5 million small accounts on behalf of members.[95] The number may have been justifiable when members could not be identified, but now many such accounts are linked to an individual's tax file number. Sums in such accounts should be returned to each member's active superannuation account where possible.

[93] See Chapter 2 for analysis of the cost savings. The beneficiaries would be people with multiple accounts today.
[94] ATO (2014). 770,000 of these ATO-held accounts belong to temporary residents.
[95] ATO (2015).

6.5 Consolidate inefficient funds

Government can do more to facilitate fund mergers. Vigorous application by APRA of the MySuper scale test would place pressure on funds that cannot show that their small size does not disadvantage their members. Yet some funds may remain reluctant to merge without a strong shift in the competitive environment. Government should therefore not expect these measures alone to deliver the full potential for $400 million in annual savings outlined in Chapter 2. They are likely to have much more impact when combined with the shift in competitive focus to net returns that a fee-focused tender for default status would provide.

Tax treatment can reduce the benefits to members of fund mergers and so deter funds from merging. Government needs to ensure that funds that merge do not disadvantage their members by triggering taxes such as capital gains tax when they transfer members' balances.[96] The current temporary provisions to minimise such tax impediments should be extended indefinitely.[97]

Rules on when members can be moved from one product to another can also reduce benefits from fund mergers. To cut costs, funds need to be able to shift accounts from products and close products. Current rules dictate that accounts can only be moved to new products if they are judged to be equivalent to the existing products.[98] Because superannuation products have many subtle

[96] Tax treatment needs to deal with CGT, 45 day disposal of assets rule and the loss of "tax-free component" (ASFA (2014)).
[97] Mercer (2014a).
[98] Superannuation Industry (Supervision) Act 1993 (Cth).

differences, the test can prevent product closures that would be likely to benefit all members. Government should allow funds to move accounts as long as they place individuals at "no overall disadvantage", as the 2010 Super System Review (the 'Cooper Review') recommended.

6.6 Prior to operating the tender, retain the FWC quality screen

The government has stated that it intends to remove superannuation from industrial awards, and so remove any role for the Fair Work Commission in superannuation. It should not do so unless another quality filter, such as a competitive tender, is in operation.

Each industrial award typically includes a short list of funds that employers can select as a default.[99] Awards are estimated to affect superannuation defaults for 20 to 30 per cent of employees.[100] Legislation brought in by the previous government requires the Fair Work Commission to choose between two and 15 MySuper products for listing on each award. This process has paused, pending appointment of a final representative to the Commission's expert panel responsible for completing the first round of product shortlisting.

Concerns have been raised about the impartiality and expertise of the Commission process. Critics argue that it will favour incumbent industry funds, will not be effective as a quality filter, will be costly to implement, and will add to ongoing costs.[101]

Removing defaults from awards without imposing another quality filter is unlikely to reduce average default fees and could well increase them. It would give employers access to efficient funds that are not currently listed on a particular award, and would expose some less efficient funds to competition. But these benefits can be largely realised with an effective quality filter. And removing a quality filter altogether would also increase costs for many funds, as they would increase sales, marketing and employer retention efforts. Employer search and evaluation costs would rise, particularly for smaller firms, and some customers would be moved to higher-cost, lower-performing funds due to employers making poor choices.[102]

It has been argued that APRA could provide a sufficiently rigorous screen for quality. Government could direct APRA to apply stringent efficiency criteria in screening MySuper products. But the current APRA MySuper qualification process is not a sufficient quality filter and efficiency has not traditionally been a major part of APRA's mandate. The Productivity Commission observes that the "Stronger Super reforms serve largely to standardise features and promote disclosure to improve comparability between MySuper products, rather than filter out any products which may not represent the best interests of employees" and that employers

[99] There are still many workers who do not have choice of fund. The FSI recommended all be given choice of fund.
[100] Productivity Commission (2012)
[101] FSC (2014). Rafe Consulting (2014), for the FSC, estimated transition costs of $265 million, including $185 million due to individuals incurring multiple sets of fees and the rest due to the costs of transferring accounts and to employers adapting to regulatory change.
[102] Industry Super Australia (2015). Diviny and Smith (2014).

are not well-placed to choose from a long list of MySuper products. It found there was “a need for a quality filter to distinguish among funds seeking listing of their products in modern awards.”[103]

APRA does require funds to submit information to help it to determine whether a fund and its directors are likely to comply with their trustee duties. While the requirement serves as a type of quality filter, it lets through many MySuper products that appear to be inferior. For example, many products offer asset allocations that are likely to underperform over the long run, or charge fees that are much higher than those of other products with similar asset allocations. The new ‘scale test’ for MySuper providers could also play a role in screening out poor products, though many of them are offered by large funds.

If the Government accepts claims that the Commission process is biased, it could retain the link between awards and default funds, but transfer the responsibility for selection of default funds for each award to a different body. But this would be inferior to running a broader competitive screen for the entire default segment, as recommended in this report.

[103] Productivity Commission (2012).

6.7 Improve the quality of the choice part of the market

More can be done to improve the quality of competition in the choice segment of the industry. Fees and costs are higher there than in defaults.[104] While more work is needed to assess how to best improve efficiency in the choice segment, three reforms are needed in the short term.

First, government must continue to improve disclosure to make products easier to compare. The Australian Securities and Investments Commission is working to improve disclosure and APRA has significantly upgraded fund reporting. It is essential to improve the disclosure of fund performance and costs in dashboards, product disclosure statements, account statements, and in reporting to APRA. Account holders, employers, funds and tender operators must be able to assess superannuation products on an objective basis.

Current disclosure requirements have been criticised for a lack of clarity. One submission to the FSI urged regulators to provide detailed guidance “outlining the specific manner in which funds must disclose fees, whilst ensuring greater transparency via the unbundling of separate disclosure of different fee types.”[105] In particular, funds appear to interpret differently the requirement to report a measure of costs called the Indirect Cost Ratio. More generally, tax and transaction costs, which can be vital to superannuation returns, are not well reported at present.[106]

[104] Rainmaker Information (2013).
[105] SuperRatings (2014a).
[106] Williams (2014); Norvaca International (2014).

Government should also improve MySuper dashboards to remove subjective measures such as target returns and emphasise objective measures such as asset allocation. Choice product disclosure should be aligned to make choice funds directly comparable to MySuper products.

Second, government should vigorously test whether funds and financial advisers are complying with their obligations to act in their members' and clients' interests – by moving clients out of high-cost products into more appropriate products, for example. Government should remove obstacles to closing high-cost legacy products. That would help funds and advisers to act in their members' and clients' interests.

Third, upon operating a default tender, government should disseminate information about the winners of the tender. They will set a tough benchmark for high-cost choice products, and people who are in these products should be made aware of the gap between the winners and their fund. The *Super Sting* report recommends that government make tax time super choice time – in other words, tender winners should be made highly visible to taxpayers as they submit tax returns online. Taxpayers should be able to compare the winners with their current fund and switch on the spot if they wish. Disseminating such information would improve the quality of competition across the system.

7. Conclusion

Australia's universal and compulsory system of superannuation was introduced in 1992 to ensure that workers provided properly for their retirement. As the population ages, compulsory super also seeks to take the pressure off Age Pension payments and the Commonwealth Budget.

The system has many strong features. Yet there is strong evidence it is not generating value for money for many account holders. Current reforms will cut costs significantly but leave billions of dollars on the table.

Administration expenses could be much lower. These expenses have no impact on gross investment returns, and so if they increase by a dollar, returns are reduced by the same amount, leaving members of the more expensive funds poorer in retirement as a result. The leanest super funds perform administration for a fraction of the cost imposed by many others, while often being rated highly for the services they provide.

Similarly, many of the fees levied for investment management do not pay their way. There is strong evidence they could be reduced without reducing gross returns.

The Stronger Super reforms have helped to some extent, and have further to run. But even if they achieve their goals they are unlikely to reduce fees by much more than 10 per cent.

Policymakers can do much better. As the FSI review argues, policymakers must do more to prune out poor products and, unless efficiency improves markedly, create a market mechanism to push for strong performance.

Our 2014 report, *Super Sting*, argues that further reform of the superannuation system in order to reduce fees is long overdue. It proposes reforms that have the potential to save billions of dollars a year in excessive fees. These reforms would sharpen competitive pressure on superannuation fees by making funds tender for the right to run a low-cost default fund that all new job starters will pay into unless they make other arrangements. A second reform will make the system transparent by enabling account holders to compare the cost of their fund with the new default fund at tax time — and to switch on the spot if they choose. A range of complementary reforms will remove excess accounts, encourage funds to merge, and improve the choices people make outside of the default segment.

The reforms will help to address a fundamental threat to the adequacy of retirement incomes in Australia. They will reduce pressure on the Age Pension and the taxpayer's dollar. A simpler, lower-cost superannuation system will increase the size of the economy by freeing up workers, managers, and capital goods to produce more value elsewhere. The time to create a more efficient and fairer superannuation system is now.

Appendix 1: Summary of baseline fees and initiative impacts

	Admin			Investment			Advice			Total		
	Default	Non-default	Total	Default	Non-default	Total	Default	Non-default	Total	Default	Non-default	Total
$ billions												
Pre-MySuper	2.0	3.9	5.9	3.0	4.8	7.9	0.2	2.2	2.4	5.2	10.9	16.1
MySuper	1.9	3.9	5.8	2.8	4.8	7.7	0.1	2.2	2.3	4.8	10.9	15.7
FoFA	1.9	3.9	5.8	2.8	4.8	7.7	0.1	1.7	1.8	4.8	10.4	15.2
SuperStream	1.7	3.7	5.5	2.8	4.8	7.7	0.1	1.7	1.8	4.6	10.2	14.9
Consolidate accounts	1.4	3.7	5.1	2.8	4.8	7.7	0.1	1.7	1.8	4.4	10.2	14.5
Tender + mergers	1.2	3.5	4.7	2.0	4.8	6.8	0.1	1.7	1.8	3.3	10.0	13.3
$ per account												
Pre-MySuper	114	483	230	173	602	307	11	269	92	298	1354	629
MySuper	107	483	225	160	602	299	6	269	88	273	1354	612
FoFA	107	483	225	160	602	299	6	207	69	273	1292	592
SuperStream	98	466	214	160	602	299	6	207	69	264	1275	581
Consolidate accounts	135	516	255	266	678	395	9	233	80	411	1427	729
Tender + mergers	112	493	231	187	678	341	9	233	80	308	1404	652
$ per person												
Pre-MySuper	212	778	406	319	971	543	21	434	163	552	2182	1112
MySuper	198	778	397	296	971	528	11	434	156	504	2182	1081
FoFA	198	778	397	296	971	528	11	333	122	504	2082	1047
SuperStream	182	751	378	296	971	528	11	333	122	488	2055	1027
Consolidate accounts	151	738	353	296	971	528	11	333	122	457	2042	1002
Tender + mergers	125	706	325	208	971	470	11	333	122	343	2010	917
bps per person												
Pre-MySuper	46	44	45	69	55	64	5	25	12	119	125	121
MySuper	43	44	43	64	55	61	2	25	10	109	125	114
FoFA	43	44	43	64	55	61	2	19	8	109	119	112
SuperStream	39	43	41	64	55	61	2	19	8	106	117	110
Consolidate accounts	33	42	36	64	55	61	2	19	8	99	117	105
Tender + mergers	27	40	32	45	55	49	2	19	8	74	115	88

Model inputs: 30.7 million accounts (17.6 million default, 8.0 million non-default, 1.0 million SMSF, 4.1m Eligible Rollover Funds (ERFs); SMSF & ERFs unchanged by any initiatives). Account size $25,000 default, $109,000 non-default. 14.7 million account holders (primary accounts by sector: 9.5 million default, 5.0 million non-default).

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