

## **Portability of Superannuation Balances**

**Michael Drew and Jon Stanford**

**O**ver the last two decades the Australian financial system has experienced substantial deregulation, but the superannuation sector has run counter to this overall trend. While the superannuation sector has become a major segment of the financial system, this growth has been the result of compulsion, not choice by economic agents.

There are two forms of compulsory contributions to superannuation. The first is award superannuation, under which employers are required to contribute three per cent of wages to a superannuation fund specified in the award. The second is the Superannuation Guarantee, under which employers are required to pay a specified proportion of salary, currently nine per cent, to a superannuation fund of their choice. Despite being compelled to invest in superannuation, employees have no effective choice about which fund is to receive their contributions, and no choice about whether to retain accumulated balances in the original fund.

Some time ago the Commonwealth government announced a new policy of allowing members of superannuation funds to have unrestricted choice on portability of accumulated balances in superannuation funds, and published the necessary regulations under the Superannuation Industry Supervision Act (SIS Act). The proposed date under which these were to become effective was July 2004, but these regulations were disallowed by the Senate in September 2003.

In this paper we argue that the resulting ongoing lack of choice violates the fundamental principle of consumer sovereignty, under which it is held that consumers are the best judges of their own welfare and ought to be able to consume anything they can afford to buy; and similarly, in the investment area, that individuals are the best judges of their own welfare, and so should be able to place their retirement savings in any product they choose. Quite apart from our value judgment that consumer sovereignty is preferable to paternalism, we argue that the lack of choice of both initial and subsequent superannuation fund leads to a lack of competition in this sector. Trustees of superannuation funds are assured of both a flow of captive contributions and stability of accumulated balances, which removes incentives to operate the funds at lowest cost, much less in line with member preferences.

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## **Defined Contribution and Defined Benefit Superannuation Funds**

Before proceeding, it is necessary to distinguish two quite different types of superannuation fund: defined benefit funds (DBF) and defined contribution (or accumulation) funds (DCF).

DBFs promise a retirement benefit defined by a formula that is usually based on final salary and years of service: the typical retirement benefit is either a pension amounting to a certain percentage of final salary, a lump sum equivalent to a certain multiple of final salary, or some combination of these. The liability to meet the promise is assumed by the fund's sponsor, usually the employer. On the other hand, in a DCF the retirement benefit is simply the accumulation of contributions, plus earnings less expenses. Under a DCF, members bear the entire investment risk, whereas in a DBF fund this risk is predominantly carried by the employer.

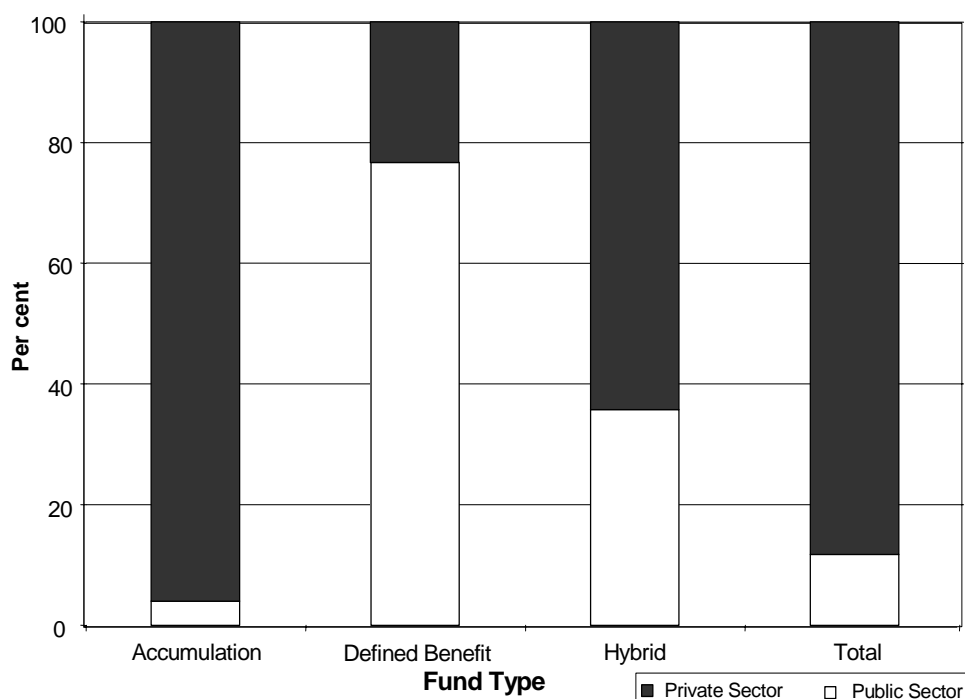
In DCFs it is appropriate that members should be able to choose the fund in which to hold their balances, since they bear the risk that trustee decisions will produce poor returns or high costs. By contrast, if DBFs are poorly managed this is a problem predominantly for the sponsor, not the member. For this reason, we argue that portability only makes sense in the case of defined contribution funds, where the value of the retirement benefit to members depends on performance of the trustee.

Figure 1 shows the membership of superannuation funds by public and private sector. The major features to note are that the overwhelming majority (over 90 per cent) of accounts are in private sector accumulation funds, and that membership of DBFs is largely confined to the public sector. Comparison with similar data for previous years also shows that membership of DBFs has been declining for some time, with a number now closed to new members. For these reasons the rest of this paper relates only to DCFs.

## **Portability of Accumulated Balances**

We take it that the goal of members of accumulation funds is to obtain the maximum terminal balance at the age when they can exit the superannuation system (after allowing for risk). The important variables determining the terminal balance are the gross investment returns earned by the fund and the expense rate of operating it (Drew and Stanford, 2002). The gross investment returns will depend on the asset allocation strategy — that is, the proportion of the fund's portfolio in each asset class — and the market return to each asset. Expenses incurred by the fund are of two major types: administrative expenses, which are usually charged as a flat dollar amount per annum, and the expenses of investing the portfolio (for instance, the expense charges by the university superannuation scheme, Unisuper, are an administrative fee of \$127 per member per year, and an average investment expense of 0.37 per cent of funds under management.)

**Figure 1: Membership of Superannuation Funds by Type of Fund and Sector, Australia, December 2003**



Note: Small Funds (those with less than 5 members), are assumed to be accumulation funds.

Source: APRA: <http://www.apra.gov.au/Statistics/Superannuation-Institutions-Statistics.cfmdata>.

Given freedom to do so, is it likely that members would be able to select funds that provide returns higher than a market benchmark? Our research shows that any superior performance by active funds managers does not persist (Drew, Stanford and Taranenko, 2001; Drew, Stanford and Veeraraghavan, 2002b); this supports the conventional wisdom that past performance of superannuation funds does not provide a reliable indication of future performance. From this we conclude that there is no information that would enable members of superannuation funds to predict future performance, and that it is therefore pointless for them to attempt to do so.

What, then, is the optimal strategy if there is freedom to choose the fund? We have shown that retail superannuation funds, specializing in the management of domestic equities, under-perform industry benchmarks, after taking into account the risk exposure of these funds (Drew and Stanford, 2003b); this research confirms findings from the US and the UK. We also have found that higher investment expenses (presumably reflecting active rather than passive portfolio management) are associated with lower returns to the portfolio (Drew and

Stanford, 2003c). Finally, we have found some evidence that even the lowest cost cohort of wholesale funds have produced slight excess returns (Drew, Stanford and Veeraraghavan, 2002a), that is, managers are able to just recover the costs of active management. With these observations in mind, we argue that the optimal strategy for members seeking to maximise their terminal benefit is simply to concentrate on minimising expenses. The general rules for achieving this end are to consolidate balances in a single fund (to avoid paying the administrative expenses fee more than once); to choose a fund that charges wholesale rather than retail fees; and to choose a predominantly passively managed fund rather than an actively managed one. Note that following these rules requires no detailed knowledge of funds or of their past performance.

**Table 1: Costs of Superannuation Fund by Type of Fund**

Type	Investment Cost	Administration Cost	Distribution Cost	Total Expense Rate
<b>Large</b>	<i>per cent of Funds Under Management</i>			
Corporate Wholesale	0.34	0.38	0.33	1.05
Corporate Employer Master Trust	0.40	0.35	0.10	0.85
Industry	0.45	0.60	0.10	1.15
Government	0.20	0.23	0.00	0.43
<b>Retail</b>				
Small Retail Employer Master Trust	0.60	0.90	0.50	2.00
Personal Super	1.24	0.60	0.50	2.34

Note: Costs exclude entry and exit fees. The key cost determinants are access to wholesale investment rates and distribution methods. On both counts, retail funds have comparatively high costs. Government funds have low costs because the administration of superannuation has been integrated into the payroll function, and because many government funds are unfunded.

Source: Rice and McEwan (2002).

The potential gains from following these rules are significant. Avoiding an administrative fee of \$127 a year would increase the terminal balance by nearly \$8,500 over 30 years (assuming an average earning rate of 5 per cent a year). The advantage of paying wholesale rather than retail fees can be seen in Table 1, in which all types of corporate superannuation funds have lower costs than retail

funds. Members could effect a saving of as much as 0.8 per cent annually by this means, and on reasonable assumptions, this would increase the terminal benefits by at least 15 per cent.

The gains from consolidating balances into passively managed funds rather than actively managed funds are also potentially high (at the extreme 0.94 per cent per year for members of retail personal superannuation funds), and are material for all members except those of government funds (for more detailed analysis of the data see Rice and McEwan, 2002).

The main point of this paper, however, is precisely that under current arrangements, superannuation fund members are not free to follow these rules. Their accumulated balances are an illiquid, unmarketable long-term asset that must be preserved in the superannuation environment until at least age 55 (the current policy is to extend this progressively to age 60 by 2025. Members have no choice of fund and no right to transfer accumulated balances from one fund to another.

Superannuation funds operate as trusts; the trustee is the legal owner of the assets in the superannuation fund and invests them for the beneficial owners, the members. But members are not allowed to appoint or direct trustees: in general, they have no influence over trustee decisions. Trustees have explicit duties under common law and the SIS Act to act prudently and in the interests of beneficiaries but, as we have argued elsewhere, they are generally inexperienced in financial matters, and tend to accept the conventions of the funds management industry as espoused by investment or 'asset' consultants and funds managers. In other words, they are effectively 'managed' by these groups — for their benefit rather than that of the fund members (Drew and Stanford, 2003a). The problem is made worse by the absence of effective consumer protection measures. The Australian Prudential Regulation Authority (APRA) has a practice of referring member complaints to the superannuation fund for reply (Stanford, 2003). Moreover, the Australian Securities and Investment Commission (ASIC), is reluctant to act on consumer complaints about superannuation fund performance (Valentine, 2003).

The restrictions on choice of fund and portability generate a welfare loss to members, as the lack of competition between funds results in higher costs and lower investment returns. The implication is that the introduction of portability of superannuation balances would increase welfare, but the interests of fund managers are threatened by proposals for portability of superannuation balances. It should come as no surprise, therefore, that the broader funds management industry opposes portability.

### **Wallis Committee Recommendations**

Several years ago the Wallis Committee (as part of the Wallis enquiry into Australia's financial system) considered investment management fees in Australia and concluded that they appeared to be higher than those in comparable countries (Wallis Committee, 1997). One of the major likely reasons for higher costs was the fragmentation of the managed funds industry, and so the committee argued

that rationalisation would be assisted by stronger competition and the removal of regulatory constraints on the amalgamation of funds. In particular, the Wallis Committee (1997) noted that the existing arrangements restricted competitive pressure in the sector by providing member choice of fund only to self-employed individuals and members of public offer superannuation schemes.

However, the Wallis Committee argued that member choice raised several concerns:

- Administrative costs for employers and funds were likely to be greater if freedom of choice was unfettered and could be exercised at will. If members exercised choice frequently, additional exit/entry fees might offset any increase in investment returns.
- Investment strategies might need to be adjusted so that funds would hold more liquid assets, and might result in a greater focus on short-term investment performance. (However, the committee pointed to US experience, which suggests that investor choice has not led to higher volatility in fund liquidity.)
- These problems might be partly addressed by imposing limitations on exit, such as a suitable notice period or a limit on the frequency of change. Subject to these constraints, however, the additional competition engendered by choice was likely to put downward pressure on costs and to encourage rationalisation of the industry.
- Member choice would be successful in promoting competition only if consumers had appropriate information. It was the joint responsibility of the industry and regulators to ensure that consumers were educated and well informed. Education should cover issues such as the rights of members, different life cycle needs and their implications for risk and return, and the benefits and costs of exercising choice.
- Consumer protection would need to encompass requirements for adequate disclosure, proper regulation of the sales and advice process (including licensing of investment advisers), and speedy dispute resolution where problems occurred.

The committee recommended that superannuation fund members should have a greater choice of fund subject to any constraints necessary to address concerns about administrative costs and fund liquidity. Finally, the Wallis Committee recommended specifically that members should have the right to transfer vested amounts to any complying fund. On exercise of that right, payments should be transferred to the chosen fund as soon as practicable, subject to controls necessary to maintain orderly management for the benefit of all fund members. Transfer costs, including those incurred as a result of regulatory requirements should be transparent and reasonable.

In our view the Wallis Committee overestimated the difficulties associated with portability. For instance, liquidity problems in fact are likely to be minimal. The effect of portability would be to re-allocate balances between funds, but there

is no possibility of a 'run' on the superannuation industry as a whole, since balances must be preserved until at least age 55. If, as we would expect, members took the opportunity to consolidate balances into a smaller number of accounts, those funds losing members would need to dispose of assets, while those gaining members would need to acquire them; sales would balance purchases in the aggregate, so there should not be significant disruption to the capital market.

If there were major transfer of balances from one class of funds to another, this would amount to strong evidence of member dissatisfaction with their initial trustees and their policies. In these circumstances it is to be hoped that trustees would review their procedures and policies so as to reduce the outflow. If they did not respond satisfactorily their funds would continue to shrink, and eventually they would find themselves out of a job. It is precisely this form of market discipline that will encourage the emergence of a superannuation industry that is more efficient and more in tune with the preferences of fund members.

We also argue that once a portability regime has been established a high level of transfers is unlikely. Transferring accumulated balances will undoubtedly be subject to exit fees and will be a somewhat time-consuming process, so the optimal strategy for maximising retirement benefits is analogous to that which should be adopted by fund managers: a passive buy and hold strategy that avoids the high transactions costs inherent in active portfolio management.

### **Current Government Proposals**

As already noted, change to superannuation policy is now back on the agenda. The current proposals of the government are as follows:

- Allow portability through changes in the regulations of the SIS Act.
- Portability is to be implemented by way of regulations (under sections 31 and 32 of the SIS Act) that will require the trustees of all regulated superannuation funds to transfer an amount in respect of a member's superannuation benefits to another regulated superannuation fund (for instance, an approved deposit fund) at the request of that member.
- The transfer will be subject to agreement of the receiving fund.
- Portability would apply to the withdrawal benefits of a fund member.
- Funds would be required to transfer benefits as soon as practicable following receipt of a request from a member, but within 90 days of the request.

The government wishes that these portability proposals be extended to members of defined benefit schemes other than public sector (Commonwealth and State) schemes but, as pointed out above, this is not necessary. Members of DBFs have an entitlement to clearly specified retirement benefits; if they are unhappy with these benefits or any other of the terms of their employment, this is a matter for them to negotiate with their employer. Freedom to choose a different employer is the DBF analogue to portability of accumulated balances in a DCF.

The following sub-sections highlight further matters of detail related to these proposals.

#### *Exit fees*

The government does not intend to impose new limits on exit fees, considering that previous action in terms of imposing a stronger disclosure regime for superannuation funds will mean that members must be informed about exit fees prior to, or shortly after, joining a fund. The government reserves the right to regulate exit fees, however, if there is evidence that exit fee arrangements are being structured for the purpose of preventing portability from operating as intended.

#### *Freezing portability*

APRA would be able to freeze the transfer of all, or a proportion of, benefits out of a fund to another fund where there are prudential concerns. Such concerns would arise if APRA had reason to believe that the transfer of funds would prejudice the financial position of the fund, or the interests of its members. In such circumstances APRA would be able to suspend or vary the fund's obligation to pay the benefit for such period as APRA determined. APRA would also have the discretion to freeze portability of benefits where the trustee of the fund had made an application to APRA to do so. Once APRA had discontinued a freeze, the maximum notification period for the transfer of benefits would recommence for any outstanding requests for transfer.

#### *Consumer protection and disclosure issues*

Many of the disclosure requirements that are necessary for portability are already provided by the Corporations Act 2001, the general disclosure requirements of which harmonise disclosure requirements for financial products, including superannuation. In addition, this Act now provides enhanced service provider licensing and conduct regimes. Disclosure requirements for superannuation funds are stipulated in the Act, as amended by the Financial Services Reform Act 2001 (FSR amendments), which came into force on 11 March 2002. These disclosure requirements ensure that all prospective members of public offer funds are made aware of the level of exit fees and other conditions prior to joining and transferring their benefits into a superannuation fund. At that time a superannuation-styled 'disclosure of interest' form is recommended or a Product Disclosure Statement (PDS) must be issued to the prospective member. The PDS must include information about any amounts that will or may be payable in respect of the product after its acquisition (including exit fees), either by the holder or out of a common fund.

### *Information about current fund*

Members require information about their current fund and the status of their benefits. The Corporations Act disclosure obligations include a requirement for fund trustees to provide certain member and fund information after each reporting period (usually 12 months). This includes:

- The amount of the member's withdrawal benefit at the start and end of the reporting period.
- The method by which that amount was worked out.
- The proportion of that benefit that must be preserved.
- The amount payable on the member's death, and details of any disability benefits.
- A description of the fund's investment strategy and investment objectives of the fund.
- A statement of fund assets and information on the fund's rate of net earnings.
- Information relating to the fees, charges, expenses and administrative or other operational costs of the fund and the amount of fees and charges deducted by the fund from any account held in respect of the member.

The government considers that fund trustees should also be required to provide information to members on request that would allow them to make an informed decision about the transfer of their superannuation benefits. This information should include the member's withdrawal benefit and amount of exit fees that would be payable at that time.

### *Market conduct*

The FSR amendments to the Corporations Act have drawn together regulations on financial advice in relation to different types of financial products into a single licensing regime for persons seeking to carry on a financial services business. Accordingly, persons who advise on superannuation products (both life and non-life products) will be subject to licensing or authorisation requirements administered by the Australian Securities and Investments Commission (ASIC). Licensed financial service providers are subject to a range of measures regulating their conduct and disclosure under the Corporations Act, designed to provide for a high level of consumer protection.

### *Education campaign*

The government would conduct an education campaign prior to the commencement of portability. The campaign would be designed to meet the information needs of both fund trustees and fund members.

## **The Senate Select Committee on Superannuation**

The Senate Select Committee on Superannuation (SSCS), which reported on the portability proposals in September 2003, purported to support the principle of portability and the freedom of individuals to consolidate their superannuation accounts (p. xiii), but believed that portability out of an active account is an issue that is better dealt with through choice of funds legislation, on the grounds of efficiency and consumer protection (p. xiv). Recall, however, that the SSCS had earlier opposed the government's choice of funds proposals, and that the Senate later rejected the choice of funds bill.

The opposition to transfers from an active fund — that is, a fund into which superannuation guarantee contributions are paid — was on the grounds that such transfers constitute choice of funds. One submission cited by the SSCS (p. 10) expressed the view that:

... portability without choice could become a backdoor version of choice: the employer pays contributions into a fund and the employee systematically channels them into a different fund.

The attitude embodied in this statement is that employer sovereignty, not consumer sovereignty, should prevail at all times. We argue that the appropriate response to the hypothetical situation above is to say that if employees do not like the fund their employer has chosen for them, then the employer's choice should be overridden. It is not the role of the employer to tell employees that their preferences will not be met.

The SSCS (p. xiv) also expressed concerns that:

... portability out of active superannuation accounts could lead to an increase in superannuation account numbers in Australia, rather than the desired decrease.

The SSCS did not provide any analysis to support this assertion. On any reasonable analysis it is extremely improbable. To be true it would require portability to lead to the opening of more accounts than would be closed. In any case, even if this assertion were true this should not be considered a problem, since the increase in accounts would be the result of members' choices.

Although the SSCS has since been wound up, it should be noted that there were substantial problems with its mode of operation and its conclusions. It acted only on submissions to it, implicitly assuming that all submissions were of equal value. It did not investigate issues raised in the submissions, much less take expert advice. A good example of this is that it did not even consider the Wallis Committee findings and recommendations, and did not seek advice from any members of that committee. Thus, submissions were dominated by self-interested parties who were allowed to make uncontested assertions, and to have them regarded as factual and valid.

The assertions of self-interested parties making submissions to the committee and were often self contradictory. One example concerning portability relates to timing of transfers between funds. The Corporate Super Fund Association suggested that members could time their departure from a fund so as to follow the allocation of reserves to members' accumulated balances, and to re-enter when reserves have been built up again (SSCS, 2003:55). The argument that members would engage in such a complex strategy contrasts strongly with the view that members do not understand superannuation and need further education to be able to make informed choices. In any case, we would argue that members should be free to maximise their returns to superannuation, and that seeking to join a fund with higher reserves is a rational strategy.

The appropriate response of a fund in these circumstances is not to deny portability, but to not hold reserves. The association asserted that holding reserves enables the smoothing of crediting rates (that is, investment returns net of expense charges) with the objective of promoting fairness between members and the perception that returns are stable over time. In fact, promoting fairness between members in an accumulation fund requires that returns are credited to members' accounts at the time they are earned. Moreover, the notion that 'returns are stable over time' is out of line with reality. Members understand only too well, given the performance of superannuation funds in recent years, that returns are highly volatile over time, and that funds are unable to reduce this volatility.

### **Counter Arguments to Concerns About Portability**

Reflecting the discussion above, some of the common objections to portability are based on the belief that either members are unable to understand superannuation, or they do not have enough information to be able to make sensible decisions about it.

We argue that with superannuation being compulsory, members have little incentive to understand it in detail. No actions are required of them under the current arrangements, under which contributions are paid to a fund irrespective of their wishes, and contributions are invested by trustees without reference to them. It would be irrational for members to seek a better understanding of superannuation since this would be costly, yet there would be no benefit to themselves. Nevertheless, surveys show clearly that there is a quite a high level of understanding of the problems of superannuation, as well as a level of dissatisfaction with the current superannuation arrangements (members are well aware of the problem of multiple accounts, and that attempts to combine accounts are frustrated by the refusal of trustees to allow transfer of balances). For instance, the results of a survey about attitudes to retirement income ('Retirement Savings: Drivers and Desires'), conducted by the Investment and Financial Services Association, indicated that respondents showed a strong preference for a lump sum on retirement, were highly averse to risk, and were also averse to retirement income products with little or no residual value, no possibility of withdrawal of capital, and no age pension benefits (Drew, Stanford and Stanhope,

2003). Thus the major problem is not a lack of information or an inability to process it, but the regulatory restriction that precludes superannuation fund members from acting on it.

### Concluding Comments

The vast majority of Australians belong to defined contribution funds, and their objective is to maximize their retirement benefit — that is, the terminal benefit paid. Given that members of such funds bear both the investment risk and the risk that their funds may not be managed efficiently, we argue that the best strategy to achieve this end is to minimise the fees paid under superannuation arrangements, and for fund managers to use a predominantly passive asset selection strategy. We base our case for portability of superannuation on the principle of consumer sovereignty. Like a number of important ideas in economics, the sovereignty of the consumer has one important qualification — that is, the agent is fully informed and is able to act to maximise their utility. It is our conjecture that welfare and efficiency would be increased by the adoption of portability, since this would generate much greater competition between fund managers.

Portability is opposed by trustees and fund managers, who fear that their own economic interests will be harmed by it. These fears are well based: portability would be predicted to reduce the number of superannuation accounts, and result in a transfer of balances from high-fee, actively managed funds to less costly managed funds.

Although it may be preferable, in principle, to provide more information to members of funds, we argue that there is already enough information available to allow members to make valid choices. Current consumer protection measures in superannuation may well be inadequate, but the market-oriented measure of removing the prohibition of portability, so as to put competitive pressure on trustees and funds managers, is far more likely to be the most effective means of improving consumer protection in this field.

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