

# SUPERNOMICS

ADDRESSING FAILURES  
OF COMPETITION IN THE  
SUPERANNUATION MARKET ■

MARCH 2010

# About Industry Super Network

Industry Super Network (ISN) is an umbrella organisation for the industry super movement. ISN coordinates collective projects on behalf of a number of industry super funds with the objective of maximizing the retirement savings of five million industry super members.

The paper was written by Sacha Vidler ([svidler@industriysuper.com](mailto:svidler@industriysuper.com)) with input from the ISN team. The paper develops concepts in an unpublished paper by Nick Coates and Geraldine Pace, both formerly of ISN.

ISN is grateful to Hazel Bateman, Paul Gerrans, Ross Clare and Mike Rafferty who provided valuable feedback on earlier drafts. Remaining errors are the author's responsibility alone.

# Contents

FOREWORD .....	I
EXECUTIVE SUMMARY .....	II
1 INTRODUCTION.....	1
2 THE STATE OF COMPETITION .....	2
2.1 Fees and net returns.....	2
2.2 Switching between funds .....	4
2.3 Fund flows .....	4
2.4 Fees and economies of scale.....	5
2.5 Increasing product complexity .....	6
2.6 Summary.....	7
3 FACTORS WHICH SHAPE COMPETITION.....	8
3.1 Consumer behaviour.....	8
3.2 Search and switching costs – financial literacy and product complexity .....	10
3.3 Remuneration of financial advice.....	11
4 POLICIES TO ADDRESS COMPETITIVE FAILURES.....	13
4.1 Passive consumers.....	14
4.2 Active consumers under advice .....	14
4.3 Active independent consumers.....	14
APPENDIX A ISN SUPERANNUATION SAFETY NET .....	15
APPENDIX B INFORMATION ASYMMETRY AND DEMAND SIDE COMPETITION .....	18
APPENDIX C SUMMARY TABLE – FEES AND RETURNS.....	20
SOURCES .....	21

## Figures

Figure 1 The more you pay, the less you get.....	3
Figure 2 Operational costs (\$ per member per week).....	5
Figure 3 Investment management fees (per cent of assets) .....	6
Figure 4 Average number of investment options, by market segment.....	7
Table 1 Net returns versus fees and commissions for 18 large super funds.....	20

## Foreword

There are three sources of market failure in superannuation: member inertia and disengagement; product complexity and low consumer financial literacy; and conflicted remuneration structures within the financial planning industry.

Two of these failures are recognised in the Cooper Review Panel's Phase 1 preliminary report *Clearer Super Choices – Matching Governance Solutions (2009)*. The third cause of market failure, conflicted remuneration structures within financial planning, is the subject of a number of recommendations made by the Parliamentary Joint Committee (PJC) Inquiry into Financial Products and Services in Australia (2009).

Supernomics explains the interaction of these three causes of market failure and the resulting cost to Australian workers and national savings of billions of dollars. This report then classifies investors and proposes measures to address market failure and increase competition in the Australian superannuation system. These include:

- an extension of the existing system of workplace defaults with representative trustees through the industrial relations system;
- a requirement that financial advisers act in the best interests of their clients;
- a ban on payments of commissions and asset-based fees from product manufacturers to financial planners; the capacity for super funds to provide low cost intra-fund financial advice to their members which is in their 'best interests'; and
- a practical and equitable solution to lost super/inactive accounts.

## Executive summary

This paper provides a briefing on the latest research on competition in the superannuation industry.

The issue of competition is critically important because it underpins much of the current philosophy of superannuation fund regulation in this country. Several major reviews are underway dealing with superannuation, but so far the issue of competition has received far too little attention.

The paper explains that while there is competition in the superannuation market – both between sectors<sup>1</sup> and between funds – in its current form this competition is not producing the expected benefits for consumers in reduced cost and improved investment performance.

Choice of Fund was introduced in 2005 with the intent of driving reduced fees and better performance through an increased level of competition between funds. However, the data show that contrary to theory and common sense, the more you pay for superannuation, the less you get: the relationship between price and performance in the superannuation market is *negative*. On average, for each additional 1 per cent of assets p.a. paid in fees and commissions, net returns fall by almost 1.5 per cent.

It is clear also that only a small proportion of members utilise their rights to choose their super fund. As few as 3 per cent of members switch fund each year, and almost half of those switches are driven by job changes. Further, almost none of the flow of funds in the market responds to persistent differences in performance, in a manner necessary to drive funds to improve returns and cut costs for members.

There are clear economies of scale in superannuation administration and funds management. However, while assets per fund have grown dramatically over the last decade, there is no clear downwards trend in fees.

Within the retail sector, improving economies of scale seem to have been offset by increasingly complex product offerings, including more investment and insurance options – a form of non-price competition. As the overwhelming majority of members take the default fund and default investment option, it is debatable whether they are getting benefit from these changes.

The welfare cost associated with this competitive failure is large. Between financial years 1996 and 2009 APRA data show that the retail fund sector has provided average annual net return on assets of 3.3 per cent compared with 4.8 per cent for industry funds (APRA, 2007, 2009a). If retail fund assets had earned industry fund net returns during this period, system assets at the end of financial year 2009 would be around \$40 billion higher than they actually are, providing an additional \$2.8 billion in investment income annually, or around \$7.7 million per day.

In the years to come, without urgently needed policy change, the opportunity cost of superannuation fund underperformance will escalate into the hundreds of billions. This cost is tangible. It will be felt by all Australians in the form of reduced retirement incomes, a smaller capital base, reduced productivity, reduced tax revenues and higher outlays for public pensions.

Competition in the superannuation market has evolved in this way because it is shaped by three factors: consumer behaviour, high product complexity combined with low financial literacy, and the commission system of remuneration for advice.

---

<sup>1</sup> The scope of the paper excludes self managed super funds (SMSFs).

Consumer behaviour is a factor for several reasons. The Superannuation Guarantee (SG) was designed to address the apathy many people have towards retirement savings. The SG is boosting retirement savings, but it does not remove the apathy itself, which is then expressed in a lack of engagement with superannuation. Researchers have also found inertia amongst relatively active and financially literate consumers, who switch funds much less than might be expected due to risk aversion.

Consumers exercising their right to choose also face a significant learning cost as they seek to understand a market with complicated products, a myriad of pricing mechanisms and incomplete disclosure. On the latter, the paper recognises the important efforts of regulators to work with industry to improve disclosure, including by producing shorter product disclosure statements – notwithstanding research from the US indicating that such steps *in isolation* may have little effect.

The complexity of financial markets underscores healthy demand for financial advice. Unfortunately, the dominant remuneration model for financial advice – over 80 per cent of payments to financial planners are from commissions – raises profound conflicts of interest questions.

Financial planners paid through commissions by the providers of retail financial products have an incentive to promote those products, irrespective of relative performance or potential benefit for the consumer. For this reason, few financial planners recommend non-profit superannuation funds, despite a wealth of data demonstrating persistent outperformance over more than a decade.

The paper recommends that the policy settings in superannuation recognise the factors which are shaping competition in the market.

Default funds and default investment options are a critical part of the system in which passivity and risk aversion continue to be major factors shaping consumer behaviour. ISN supports the decision by the Australian Industrial Relations Commission (AIRC) to identify default superannuation funds within the new consolidated awards to be maintained by its successor Fair Work Australia (FWA).

Members acting under advice need to be confident advisers are acting in their best interest. To align the interests of advisers with their clients, the paper recommends regulation that subjects financial planners to a legal requirement to act in the best interest of their client and prohibits models of remuneration involving payments from product providers or fund managers and ongoing asset based fees.

The recent releases by the advice and funds management industry bodies of proposed new voluntary regimes touching on the remuneration of financial advice are significant concessions that current practices are inappropriate. However, they can only be interpreted as initiatives to head-off needed regulation.

The suggested voluntary regimes only apply to new members, and do not address existing retail sector products – which hold over \$300 billion in assets – and will under current policy reduce retirement savings due to commissions for years to come.

# 1 Introduction

The Australian superannuation market has over 200 large funds directly competing to provide services to the whole community.<sup>2</sup> Regulatory constraints on competition in workplace superannuation have been removed for most workers.<sup>3</sup>

Nonetheless, profound issues remain with competition in this market. The large retail sector funds, including those owned by banks, exert market power by virtue of vertical integration – from funds management through to distribution channels including financial advice. Specific parts of the value-chain, including administration and asset consulting, are relatively concentrated.

Moreover, competition between funds is not driving price and performance improvements as expected. This paper discusses the Industry Super Network's own research, along with papers by several other researchers that show persistent performance differentials between funds and sectors over time.<sup>4</sup>

Recent developments in the theory of competition can help explain this apparent paradox. There is a growing awareness that the links between competition and efficiency are subtle and complex. As John Vickers (1995), of Oxford University, puts it:

“competition problems...are by no means easy to analyse. Faith in some general and indiscriminating notion of competition offers little guidance as to their solution. Reasoning about competition problems requires more detailed theoretical understanding and of course empirical analysis, of how competition (of different kinds) works (in different circumstances).”

This paper explains that while there is competition in the superannuation market – both between sectors and individual funds – in its current form this competition is not producing the expected benefits for consumers in reduced cost and improved investment performance.

The paper is structured as follows. Section 2 describes the level and form of competition. Section 3 explains this outcome in terms of consumer behaviour and conflicted financial advice. Section 4 provides policy recommendations. Appendix B describes the increasing focus in research and policy on the demand side – looking at consumer behaviour – for ensuring competition promotes efficient outcomes.

A companion paper to be released separately - *Australia's Lost Super Revisited* - provides an estimate of the welfare cost of competitive failure.

2 Official statistics indicate that as at June 2008 there were over 500 large 'APRA regulated' funds. Over 200 of these were 'public offer' funds. These public offer funds held \$527 billion at June 2008, of which 45 per cent was managed by the largest 10 and 64 per cent by the largest 20 funds (APRA, 2009a). This level of market concentration is lower than in comparable industries, notably banking and insurance. Non-public offer funds may also compete – for workplaces – by attempting to sign up new employers.

3 Choice of Fund, introduced in 2005, allows most workers to choose the fund which receives their workplace contributions. At the same time, regulatory change improved portability allowing balances to be rolled over between competing funds more easily. Nonetheless, some regulatory obstacles do remain, with some workplaces still not permitting choice and some funds not allowing outward rollovers. In addition, some workplaces have found it difficult or expensive to implement choice, with the result that in practice some workers cannot exercise their legal right to choose.

4 APRA's superannuation statistics tell the story. For analysis of this and other datasets, see Coleman et al (2003), APRA (2007), Ellis et al (2008) and Bryan et al (2008).

## 2 The state of competition

Choice of Fund came into force on 1 July 2005. The legislators introducing Choice of Fund believed it would lead to increased competition between funds for market share which would drive reduced fees and better performance (Senate Select Committee on Superannuation, 2002).

The reform was entirely consistent with the recommendations of the Wallis Inquiry (1997). While the view among leading superannuation researchers was mixed, Drew and Stanford (2003) were supportive, predicting that increased choice would address principal-agent problems by allowing members to:

select their own agent to nominate and monitor the fund for their contributions; ...[with] the ultimate sanction of withdrawing and transferring their balances. This creates the incentive for trustees to be responsive to members' wishes and to be more accountable for their decisions.

At this stage, indications are that these expectations were excessively optimistic. In this section, evidence is presented which demonstrates that in the current superannuation market:

- (i) there is a persistent *but negative* relationship between price (in fees and commissions) and performance (net returns);
- (ii) there is very limited active choosing of super fund (Roy Morgan, 2009) leading to quite static market shares;
- (iii) the limited fund flows that do take place are driven primarily by size of fund, with only a tenuous relationship between net returns and fund flows (Bryan et al, forthcoming 2010);
- (iv) there is a trend to increased product flexibility and complexity with dubious value-add for most consumers (i.e. competition on non-price factors); and
- (v) significant economies of scale due to increased funds under management and fund consolidation have not as yet translated into fee reductions or higher net performance.

### 2.1 Fees and net returns

In an efficient market, the law of one price ensures that consumers pay an equivalent price for an equivalent product. In terms of superannuation, that would imply a given level of fees and commissions for a given level of net returns. Consumers would only be prepared to pay higher than average fees for higher than average returns.

A series of analyses in recent years have shown this not to be the case.

Evaluating super fund returns from 1996 to 2002 Coleman et al (2003) found that retail funds provided average returns of 4.5 per cent pa, 1.3 per cent lower than industry funds and 1.7 per cent lower than all not for profit funds.<sup>5</sup> They also found 'evidence of a negative relationship between returns and expenses. This suggests that fund members receive little advantage from investing in superannuation funds with high expenses.' Coleman et al also found that a number of (mostly retail) funds provided returns below the risk free rate. Such underperformance would not be sustainable in an efficient market, in which investors need to be compensated for volatility by returns exceeding the risk-free rate.

<sup>5</sup> It is worth noting that corporate funds and public sector funds often face limited competition in their own workplaces and can therefore partly or fully avoid some costs, such as marketing.

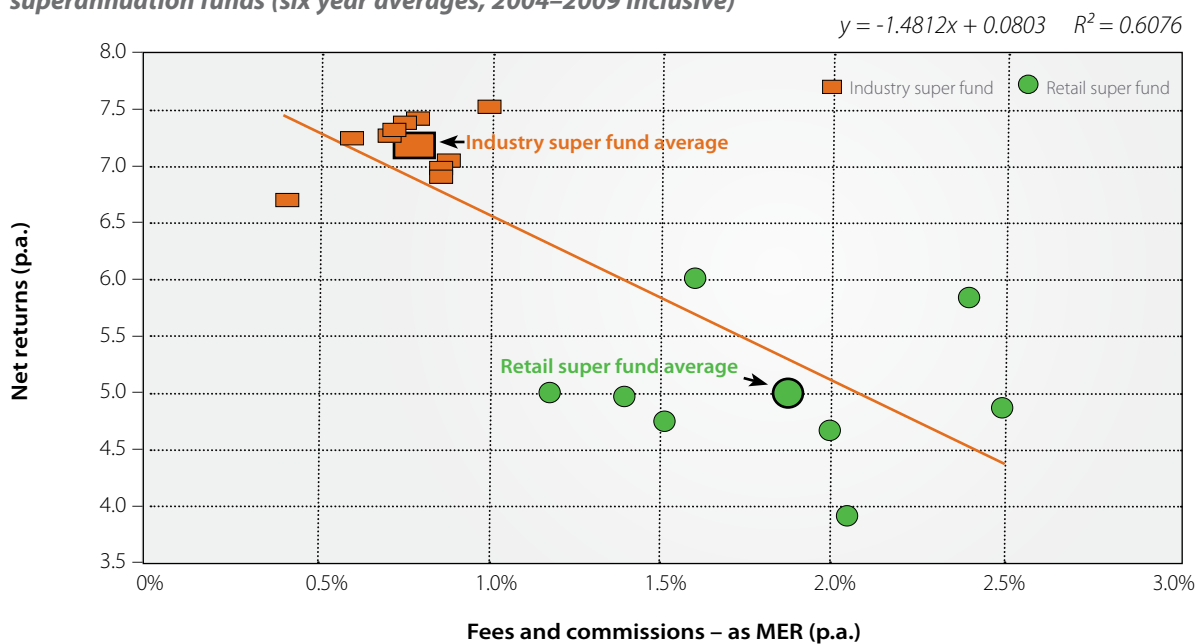
APRA (2007) reinforced these findings, presenting data for the period 1996 to 2006 showing that retail funds provided average returns of 5.3 per cent pa, 1.4 per cent lower than industry funds and 2.2 per cent lower than all not for profit funds.

A 2008 paper by Ellis et al explored performance differences between funds, finding that differences between the not for profit sectors were not statistically significant, but that the lower performance of retail sector funds was statistically significant. They found that differences in fees and commissions were the single largest factor contributing to the different level of performance. Among other points made were that annual fees in the retail sector are four times higher than in the not for profit sector on average.

ISN has analysed a dataset supplied by Rainmaker derived from the annual reports of 18 very large superannuation funds (ten non-profit funds, four corporate master trusts and four personal master trusts), together holding around 30 per cent of industry assets. The dataset includes net returns and price (fees, commissions and investment costs) for each fund for the six years from 2004 to 2009, inclusive.<sup>6</sup> The investment option is the default option, or the largest option for personal retail funds that have no formal default option.

### Figure 1. The more you pay, the less you get

**Net returns versus fees and commissions (expressed as an MER) for the default option of large superannuation funds (six year averages, 2004–2009 inclusive)**



Assumption: Corporate retail funds assume discounts applicable to customers with \$10 million in assets.

Source: Rainmaker (2009) and author's analysis; summary table at Appendix C.

The data strongly suggest a negative relationship between price and returns (the least squares regression line slopes downwards) which is the opposite of what would be expected in an efficient market.

The dispersion around the regression line – more noticeable for retail funds – is in part due to the relatively small sample size. Nonetheless, an  $R^2$  figure of greater than 0.6 indicates that price is a very important, if not dominant, determinant of returns.

On average, over the last six financial years, members in the default or largest investment options in the largest public offer superannuation funds lost almost 1.5 per cent pa in net returns for each additional percentage point they paid in fees.

<sup>6</sup> Members are assumed to hold a balance of \$50,000 and contribute \$5,000 pa. Corporate master trusts are assumed to provide fee discounts typical for corporate customers with \$10 million in assets. Many small business customers would have less than \$10 million in assets and therefore not qualify for such discounts.

The figure also highlights that governance structure (not for profit funds have representative trustees whereas for-profit retail funds do not) is informative about both performance and price. The quadrant of above average returns and below average fees is inhabited only by not-for-profit funds.

## 2.2 Switching between funds

Despite Choice of Fund, switching between funds is limited.

Since its introduction in June 2005, Roy Morgan has published historical data on two variations on a question asking if respondents have switched fund in the last 12 months. The positive response rate to the former question has fallen from around 5-6 per cent in 2005, to a fairly stable 2.7-3 percent since 2007. There is a fairly consistent difference in results between the two questions due to some respondents opening a new fund without closing their previous fund (ie. acquiring multiple accounts).

ISN estimates that the cumulative total of these series from June 2005 to June 2009 is around 13-15 per cent. Even if we assume that no individuals change fund more than once (so that all of the switches recorded are unique individuals) the data suggest that the overwhelming majority of super fund members have not switched fund. The ISN estimate is broadly consistent with a 2008 estimate from Ernst and Young (2008: 13) that 10 per cent of super fund members had chosen their fund (to the third quarter 2008) based on their own public survey. The result of McNair Ingenuity's (2008) research commissioned by the Association of Superannuation Funds of Australia (ASFA) that 8 per cent of members switched funds in the year to September 2008 (down from 16 per cent the previous year) is difficult to reconcile with either the Roy Morgan data or Ernst and Young's estimate.

Switching is often driven by changes in workplace, which means that switching is not strictly equivalent to choosing – and a lack of switching is not the same as a lack of choosing (these issues are discussed in section 3.1, below). Nonetheless, if shifting assets from one fund to another is the member's main tool to exercise control over funds and address agency problems, a lack of switching demonstrates that very little pressure is being brought to bear on funds via this mechanism.

## 2.3 Fund flows

For market forces to discipline superannuation providers, members must respond to price and performance measures by shifting assets from consistently poorly performing funds to consistently strongly performing funds.

As discussed above, the quantum of switching has been quite low. A second question in relation to the limited switching, or fund flows, that do occur is: 'what is driving them?'

Fund flow research overseas, particularly in relation to the US mutual fund market, has found that performance is only one of several factors (and a relatively weak one) that guide fund flows. Other factors such as marketing spend and the recommendations of advisers have been found to be more important influences on consumer behaviour (Freeman, 2007).

ISN has commissioned analysis on fund flows by the Workplace Research Centre in the Australian superannuation market. A soon to be released paper (Bryan et al forthcoming 2010) describes an analysis which considers the influence of 1, 3 and 5 year returns on fund flows, along with a range of other factors.

The most influential factor was the size of the fund (after controlling for the positive impact of size on performance), which had a disproportionate impact on flows, suggesting that distribution channels (such as networks of affiliated financial planners) and brand awareness were important drivers of consumer decision-making. 1 year and 5 year returns are not statistically significant influences on fund flows. 3 year returns were influential, but weakly so.

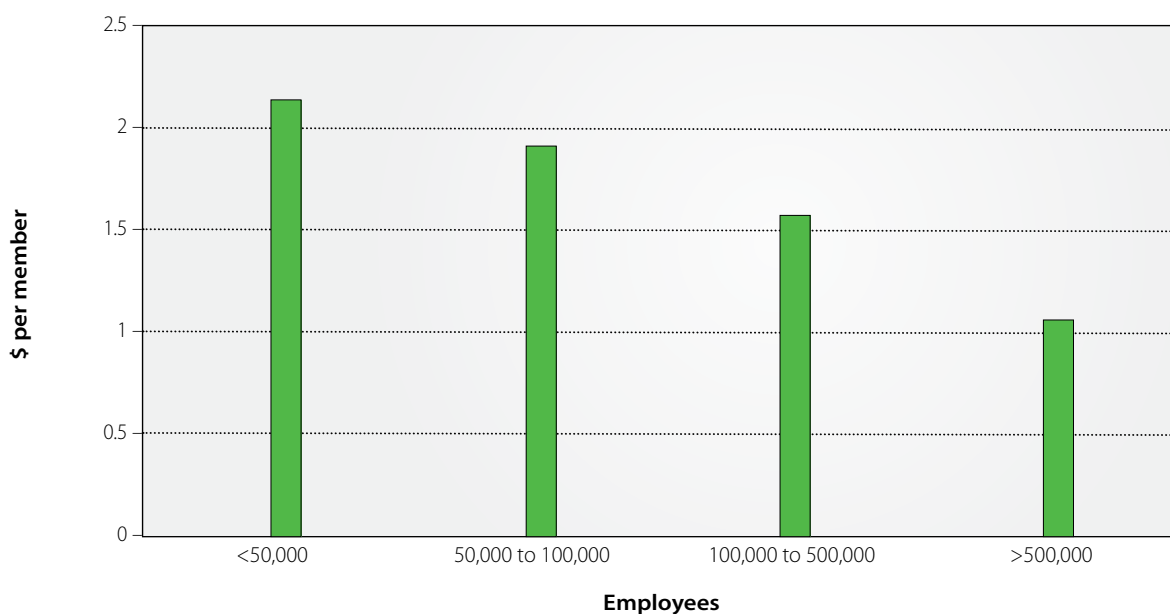
In summary, fund flows are far too small to effectively discipline fund performance, and, in any case, are driven more by size than performance. This all suggests that market forces alone do not appear likely to control principal-agent problems.

## 2.4 Fees and economies of scale

Numerous studies of the cost of Australian superannuation have found evidence of economies of scale, including Coleman et al (2003), Bateman and Mitchell (2004) and a recent study by Deloitte (2009).

The latter study finds economies of scale in both administrative and investment management costs (see Figures 2 and 3), contributing to median net returns over 5 years (2004–2008) being 0.9 per cent higher for funds with over \$1 billion in assets compared with funds with less than \$1 billion in assets.

**Figure 2. Operational costs (\$ per member per week)**



Source: Deloitte (2009)

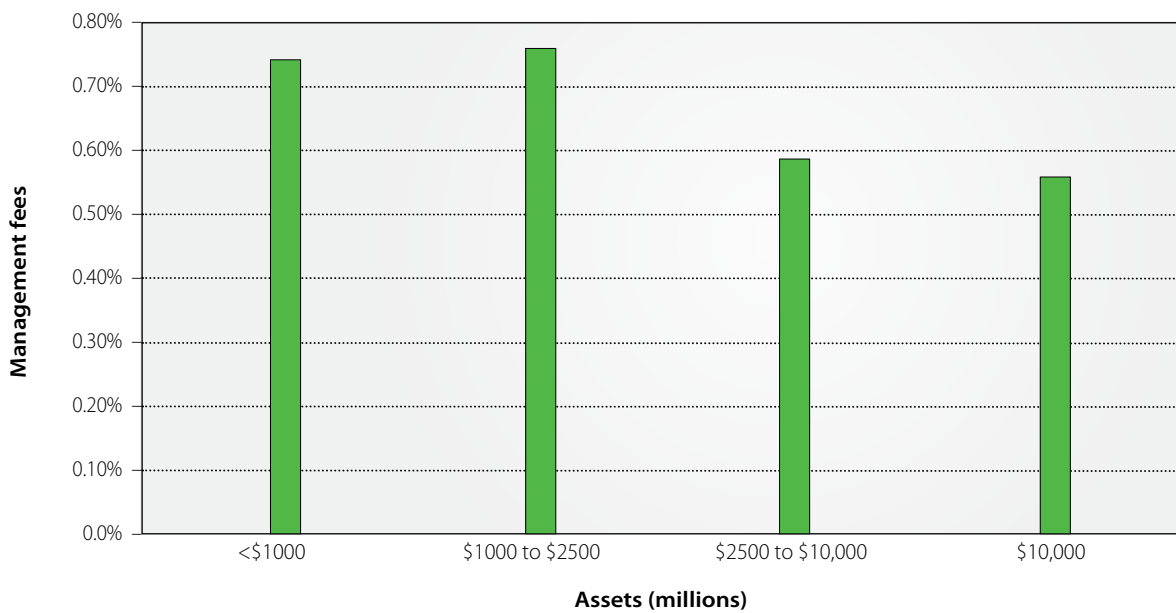
ChantWest (2008) also find evidence that costs vary by 10–20 per cent within market segments based on average account size.

The presence of economies of scale confirms that there are fixed cost elements to superannuation administration and investment management. These factors should result in unit costs falling over time as fund assets and members grow (due to both industry growth and consolidation) and average account sizes increase (as the system matures).

Between 2002 and 2008, industry assets increased from around \$520 billion to \$1,170 billion, and the assets in large funds increased from around \$425 billion to \$810 billion. At the same time the number of large funds has fallen from over 2,900 to around 500. Excluding small funds, average assets per fund have consequently increased from \$140 million in 2002 to \$1.6 billion in 2008. Notwithstanding some one-off merger costs, we would expect that this change would bring a significant reduction in unit costs. In an efficient market, these cost savings would be passed on to members.

The evidence from the various data sources offers little indication that this is the case. RiceWarner (2009) has found that costs (as management expense ratios - MERs) have fallen over this period from 1.37 per cent to 1.21 per cent. This is mainly due to reductions in costs in one market segment, large corporate master trusts.<sup>7</sup> On the other hand, ChantWest (2008) presents data for 2005 to 2008 which shows retail and public sector being stable and industry fund fees rising. Rainmaker (2008) data shows MERs rising for large funds in both retail and industry sectors.

<sup>7</sup> There is some evidence that reduced prices by retail funds in this market segment are a form of loss-leading, where the profitability comes later when members are switched or 'flipped' into personal superannuation products when they change employer.

**Figure 3. Investment management fees (per cent of assets)**

Source: *Deloitte (2009)*

Taken together, these studies suggest there has been no clear systemic change in unit costs during a period in which average assets per fund increased more than ten fold.

Possible explanations for this include that the benefits from increasing scale economies have been partly offset by direct costs associated with choice and competition, including marketing, as well as the cost of increasing product complexity.

## 2.5 Increasing product complexity

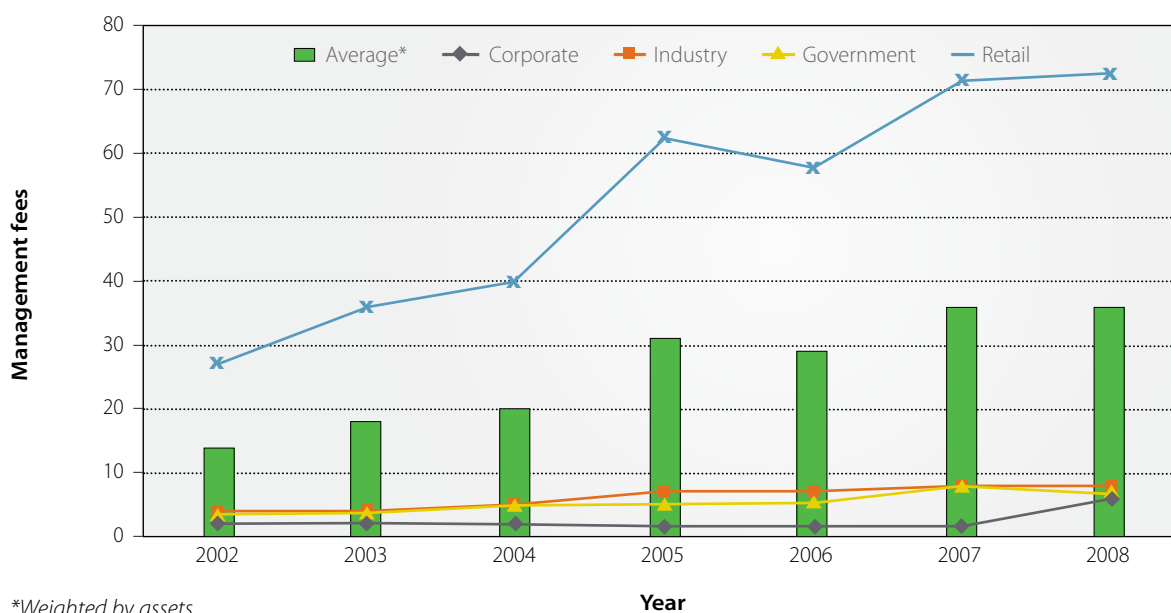
Competition between funds has not had any clear impact on cost or performance. However, other trends are apparent. In particular, the complexity of products offered has increased over time. This trend partly reflects an effort on the part of non-profit funds to provide a 'richer' product offering.

One obvious dimension of this trend is the average number of investment options offered by funds. Across all market segments (excluding SMSFs), the average number of investment options has risen from 14 to 36 between 2002 and 2008 (see Figure 4), with all fund segments showing an increase. Retail funds – both personal and corporate master trusts – started at a higher level and continue to leading this trend by a considerable margin (Rainmaker, 2009).

The average number of insurance options available has also increased. In workplace superannuation the average number of insurance options has increased from 7 to 30 across all market segments (Rainmaker, 2009).

The superannuation market shows a trend to increased product complexity, combined with fairly stable prices. This pattern is consistent with monopolistic competition in which firms compete via product differentiation rather than on price.

**Figure 4. Average number of investment options, by market segment**



\*Weighted by assets

Source: Rainmaker and author's calculations

As many consumers remain in default funds and default investment options, it would be more advantageous for most consumers to see price and performance improvements in these options, rather than having the funds loaded with rarely utilised product complexity.

Members may gain advantage from the option-value associated with rarely utilised product features; however, as many consumers remain in default funds and default investment options, their interest is most directly served by price and performance improvements in these products. Finally, increased product complexity further reduces the transparency and accessibility of the industry and arguably makes consumer engagement more difficult to achieve.

## 2.6 Summary

Persistent underperformance, particularly in the retail sector, indicates that many superannuation consumers tolerate paying more for less – against their own interests.

Poorly performing super funds are not pressed to improve net performance. By contrast, funds that have performed well historically have felt compelled to take on more expense by offering more investment choice, and implementing expensive administrative arrangements such as unit pricing to better facilitate option switching, which relatively few members will utilise.

Direct competition against 200 other public offer funds has somehow not compelled funds to pass the financial benefits associated with rapidly growing assets under management back to consumers through reduced fees or better performance. Together with heavier brand marketing, and increased investment and insurance options, the lack of clear benefit for consumers from increasing economies of scale suggest funds are engaging in non-price competition, a feature of monopolistic competition. This form of competition may allow funds to maintain higher margins or a 'quieter life' for fund trustees and employees.<sup>8</sup>

These outcomes indicate that superannuation is a market in which conventional economic assumptions such as perfect information appear not to hold. If it was, strong price competition would drive retail funds to operate and price more like non-profit funds. Instead, there are signs potentially emerging of the opposite, with non-profit funds offering a more complicated and bundled product. Closer examination of how consumers respond to price signals and other key product information is necessary to understand competition in this market and design an appropriate policy framework.

<sup>8</sup> "The best of all monopoly profits is a quiet life." (Hicks, 1935)

## 3 Factors which shape competition

Competition in the superannuation market is fundamentally shaped by three factors.

### 3.1 Consumer behaviour

First, many superannuation consumers are essentially passive.

As discussed above (section 2.2), only around 3 per cent of members switch fund each year. Much of that switching is not active choosing, with around half of respondents saying that changing job was a factor in the switch and over 40 per cent saying it was the only factor (Roy Morgan, 2009).<sup>9</sup>

The prevalence of 'passive switching' (ie. driven only by employment changes), raises the issue of account proliferation. When a worker gets a job with an employer that has a different default fund from their previous employer, the 'do nothing' outcome is to acquire a new account, while keeping the old one. It takes action to consolidate accounts, whether sticking with the previous fund or rolling assets into a new fund. There were 32.7 million superannuation accounts as at June 2009, up by 2.3 million on 24 months before (APRA, 2010). While some individuals may justifiably have more than one account, the extent of account proliferation suggests that many individuals do not consolidate balances when they acquire new funds in new workplaces.

Passivity and work place super also raise the issue of marketing strategies based on 'flipping'. Flipping occurs when consumers leaving a workplace whose default fund is a corporate master trust are transferred automatically into the fund's corresponding private master trust with significantly higher fees (SMH, 19 July 2009; InvestorDaily, 17 September 2009).

Data highlighting the limited extent of active choices cannot, in isolation, prove the extent of passivity, because the group who have not exercised choice may include some who are informed but inactive because they are content with their current offering. Recent research on enrolment in default investment options by a major industry fund<sup>10</sup> indicates that members in the default investment option may be divided into three approximately equal groups according to their level of engagement: one group was 'unknowingly' in the default option (having no awareness of what the default option was or that they had alternate investment options); a second group was aware they were in the default option and that there were alternatives but gave apathetic reasons for being in that option (such as that they were unsure of how to change, that it would take too much time or that they were not interested in investment issues); whilst a third group gave reasons for being in the default option that indicated they had given the question some consideration and thought it the appropriate investment option.

The attitude of members enrolled in a default fund could be divided in a similar manner. Without making assumptions about the relative size of the groups based on this research, it would be fair to say that members who either were not aware they had a choice, or had not exercised choice for apathetic reasons could be disadvantaged unless the workplace default fund in place had representative trustees and strong net returns.

There are a number of reasons why so many superannuation consumers are passive. One important factor is that many superannuation consumers are participants in the market not because they have chosen to save instead of spend, nor because they have chosen to buy a particular investment product over another

<sup>9</sup> On the other hand, some non-switching implies choosing. A worker who moves to a workplace with a different default fund but is happy with their existing fund and does not switch fund is choosing.

<sup>10</sup> For reasons of commercial confidentiality the fund will not be named publicly.

but because of the Superannuation Guarantee (SG). The SG requires that employers make superannuation contributions on behalf of almost all employees. This is the second pillar of Australia's widely lauded multi-pillar retirement income system.

The SG was established to address Australia's very low retirement incomes while avoiding the budget pressures associated with higher public pensions. The system, like all compulsory pension systems, addresses the apathy most people (especially the young) feel towards retirement savings. This tendency, sometimes referred to as 'myopia', reflects excessive discounting of remote costs and benefits.<sup>11</sup> The SG system addresses myopia by ensuring that savings are made and preserved for retirement on behalf of almost all workers.

However, the SG does not (and probably cannot) remove the underlying apathetic attitude towards retirement savings, especially amongst young workers, which is subsequently expressed in the undemanding, even unaware, manner many members interact with the market. Members in the market purely because of the SG have been described as 'conscripts rather than volunteers' (Bryan et al, 2010 forthcoming).

A second factor which discourages active choices is risk aversion. Recent behavioural research has found that, as well as demanding increased returns to compensate for increased volatility (as predicted by traditional financial theory), investors place greater weight on avoiding losses than achieving equivalent gains (Knetsch, 1989 in Fry et al, 2007). Also, rather than viewing all possible portfolios equally, they tend to view the currently held portfolio as a reference point.

In combination, these observed tendencies result in investors being more reluctant to change held investments than predicted by traditional theory. This is because the chance of achieving a lower return in an alternate portfolio is over-valued relative to the chance of achieving a higher return. With these biases, investors make changes to portfolios only when the chance of a positive relative performance *significantly* outweighs the chance of a negative relative performance. These tendencies have been found to be more powerful with greater uncertainty (Sethi-lyengar et al, 2004 in Fry et al, 2007).

Fry et al (2007) have investigated whether this analysis applies to Australian superannuation investors. The researchers drew survey respondents from a group of financial magazine readers, who might be expected to be both more engaged and more financially literate than average. However, the research did indeed find evidence of inertia, which is interpreted to reflect loss aversion. This research suggests that switching will be lower than optimal even amongst relatively engaged and well-informed consumers for whom passivity is probably not an issue.

A third set of factors which reduce switching are institutional. These include product pricing strategies which discourage switching, the most obvious of which is high exit fees. IFSA reportedly estimates up to 25 per cent of all funds under management – hundreds of billions of dollars – are in legacy products (SMH, 18 November 2009). The trend in new products is for exit fees to be lowered. However, substantial contribution fees remain the norm for retail products, and these can also discourage switching. A consumer who knows they are losing up to 5 per cent of funds upfront to contribution fees, may feel that to get value out of the product – to in some sense make that money back – it is necessary to stick with it for at least the medium term.

Other factors which reduce switching may include employers unwilling to take on the administrative burden of dealing with multiple superannuation funds.

In summary, levels of switching are lower than might be expected due to consumer passivity, risk aversion, and institutional factors which reduce choice in practice.

---

<sup>11</sup> In recent decades, economic theory has recognised and begun to explore why individual decision-making is often apparently inconsistent with rational maximising behaviour. 'Behavioural economics' takes bounded rationality and imperfect information into account in considering decision-making and policy. Bernheim and Rangel (2008) in the *New Palgrave* provide an overview of behavioural economics including a summary of its application to retirement savings. Benartzi and Thaler (2007) survey the discipline and, in Thaler and Benartzi (2004), describe the design and implementation of an 'opt-out' workplace retirement savings scheme to counteract self control issues which, along with myopia, otherwise reduce retirement savings.

### 3.2 Search and switching costs – financial literacy and product complexity

A second factor is that superannuation products and their pricing are so complex that their assessment is a challenge for financial professionals, let alone the average consumer whose level of financial literacy is quite low.<sup>12</sup>

Making the jump from being an inactive superannuation consumer to being an independent, active superannuation consumer, carries a tremendous learning cost. Switching costs, including learning costs, can limit competition even in the presence of many suppliers (Farrell and Klemperer, 2007).

In the superannuation market, to make the transition from inactive to active consumer, an individual must acquire a basic understanding of:

- (i) finance and investment, including key concepts such as the risk-return relationship, the equity risk premium, and the merits and limits of diversification;
- (ii) financial products – effectively, how the factors in the previous point are reflected in the various offerings from the many competing funds;
- (iii) the variety of ways financial products can be priced (and the comparative impact of different pricing structures on net returns over time); and
- (iv) the ways various financial products interact with the tax-transfer system.

Despite some recent efforts by regulators,<sup>13</sup> the range of information sources on financial products including superannuation is potentially overwhelming, and marketing and promotional material is difficult to interpret.

As is recognised by both ASIC (2009) and Treasury (2009) in recent public submissions, the average superannuation consumer faces profound information asymmetry, with product providers having the advantage of detailed knowledge of the market which most consumers are unlikely ever to achieve.

Underscoring the competitive benefit achieved for retail funds by the current lack of transparency, that sector campaigned vigorously against APRA's effort to improve information available to members by publishing fund level return data. When unsuccessful, the retail sector has resorted to a campaign to discredit the data, and proposes instead that data be published at the investment choice level. Underperformance at the fund level will be relatively easy to disguise amongst data tracking an estimated 30,000 investment options.

Given the complexity and opacity of financial markets, it is not surprising that there is a large and growing demand for financial advice, met by accountants and financial planners, who offer to guide financial decisions including choice of superannuation fund. However, the use of advisers raises a principal-agent issue,<sup>14</sup> with poorly informed customers having very limited ability to establish whether the advice received is of high quality and reasonably priced.

This raises the third factor which fundamentally shapes competition in the superannuation market: the commission system of remuneration for financial advice.

12 Findings from a 2006 report by Mercer include that two-thirds of working Australians are not sure if their superannuation fund is a defined benefit or an accumulation style fund, over half are unsure of the basic definitions of growth or defensive investments, two-fifths did not know if their funds are largely invested in either aggressive or conservative strategies and over one-fifth held three or more accounts.

13 The Financial Services Working Group and APRA (2009b) are currently running initiatives to, respectively, simplify Product Disclosure Statements (PDSs) and publish fund level performance results. While both initiatives are important and positive, they represent incremental steps towards addressing the information asymmetry faced by superannuation consumers. Unfortunately, in terms of the former effort, recent research from the US mutual fund market finds that simplified product descriptions have no discernible impact on investor decision-making, even for subjects with above-average levels of financial literacy (Beshears, 2009). These findings emphasise that disclosure alone will not ensure market efficiency.

14 More precisely, use of an adviser for financial advice is a classic principal-agent problem. These arise where information asymmetry limits enforcement of a contract. Shareholder-manager, employer-employee and consumer-firm relationships are all subject to principal agent problems if the principal doesn't have the data, skills or time to observe how honest, effective, or productive the agent is being. Markets for advice are particularly prone to these problems because people seeking advice about a market (almost by definition) do not fully understand it. The relevance of principal-agent issues for the superannuation market was raised by Drew and Stanford (2003).

### 3.3 Remuneration of financial advice

Upfront and trailing commissions and other asset based advice fees account for an estimated 84 per cent of financial planner revenue (Investment Trends, 2009, cited in ASIC, 2009). Under this model, the adviser seeks little or no direct payment, such as time-based fees, from their client. Instead, the adviser is paid a percentage of funds under advice by retail sector product providers on both an upfront and ongoing basis. These funds are withdrawn from clients' accounts.

Although superficially affordable – and attractive to consumers for this reason<sup>15</sup> – the total direct cost of this fee structure over time will almost inevitably be much higher than any plausible upfront fee.

A rule of thumb suggested by Peter Diamond, of MIT, for estimating the final impact of annual percentage asset based fees (such as trailing commissions) is that they have a 20 fold impact on retirement accumulation, such that a 0.5 per cent trailing fee will reduce accumulation by around 10 per cent.<sup>16</sup> A worker on average wages (\$60,000) should accumulate around \$430,000 (indexed for wages) over a 40 year working life, suggesting that a 0.5 per cent trail will cost a worker around \$43,000 in today's money. An upfront fee of 3 per cent (fees of up to 5 per cent are standard) will further reduce the accumulation by 3 per cent, costing approximately \$13,000. Further commissions in the post-retirement phase would see the total direct cost of advice topping a full year's wages.

Certain interest groups advance the argument that reform requiring a move away from commissions (or asset based fees) would make advice less affordable (see, for example, the testimony of IFSA and the FPA in JCCFS, 2009). In fact, such a reform would merely make the cost of advice more transparent. For this to be problematic, it is necessary to argue that it is better for individuals to be overcharged over time for advice they would not otherwise purchase, than for the financial advice industry to demonstrate the value of their service and cost it accordingly.

Dramatic as the direct cost may seem, the more powerfully destructive effect of this pricing structure is indirect. For individuals this is the opportunity cost associated with not choosing a better performing fund. For the Australian Government, the opportunity cost is the loss of public revenue from reduced taxation of earnings on superannuation assets and increased outlays to fund pensions for more retirees with inadequate superannuation savings. For the economy as a whole, it is the constraint on competition in those markets, including superannuation, in which the commissions system is dominant.<sup>17</sup>

<sup>15</sup> Market research shows members are more sensitive to the price of advice if payment is required upfront (Forethought, 2009). As members are less sensitive to payments for advice deducted over time, it is not surprising that research by Rice Warner (2009) shows financial planning paid for by commissions can cost consumers up to 13 times more than when paid for on a fee for service basis.

<sup>16</sup> A worker who is charged one percent of balances each year will have an accumulated balance at retirement nearly 20 percent smaller than if those charges were fully avoided. Indeed, the ratio of the reduction of the accumulation over a 40-year career to annual charges on assets is roughly 20 to one, since over a 40-year career, deposits remain in accounts for roughly 20 years on average." (Diamond, 2005) This approach excludes two factors, promotional wage increase over time and the impact of compounding; however, these two factors work in opposite directions and roughly cancel each other out, with the result that Diamond's 20-fold heuristic is quite accurate.

<sup>17</sup> A companion paper to be released separately - *Australia's Lost Super Revisited* – will detail these estimates.

Advisers reliant on the dominant remuneration structure only get paid by recommending funds which pay commissions (or other potentially conflicted remuneration payments such as asset based fees) – and when recommending within this group are further incentivised to recommend products with the highest commissions. The structure completely precludes recommendation by such advisers of products from the not for profit sectors which do not pay any commissions or other asset based advice fees and are, partly by virtue of this fact, demonstrably superior. It is this pernicious impact of the commissions system that undermines beneficial competition in the superannuation market.<sup>18</sup>

In an effectively functioning market, competition ensures that an entrepreneur must serve her customers' interests to serve her own interest. Over two centuries ago, Adam Smith observed that an attractive and powerful feature of efficient markets is that they harnessing individual self-interest – rather than charity – to drive positive social outcomes.

It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages. (Book I, Ch.2, Wealth of Nations)

These dynamics should apply to advisers just as they do to butchers or bakers. However, the commissions based remuneration model forces a financial planner to choose between his own interest and his clients' because it rewards an expensive distribution model and poor performance. Far from mitigating principal agent issues, it reinforces them. Indeed, it is hard to conceive of an institutionalised pricing structure that would more perfectly misalign incentives.

The commissions-based remuneration model for financial advice is at odds with the principles of competition in all the markets it affects, and is completely inappropriate for superannuation – a retirement savings scheme supported and strengthened by government mandates and incentives.

Recent announcements by the representative bodies of retail funds and the advice industry that commissions are inappropriate and will be voluntarily phased out represent a significant milestone in the evolution of superannuation (IFSA, 2009; FPA, 2009). However, in terms of the prospective implementation of these voluntary codes, it is worth noting that the proposals of these organisations would primarily result in commissions being replaced by asset-based fees, exclude commissions paid on life insurance (often bundled with superannuation) and only address products sold going forward, not the \$300 billion in retail superannuation products currently in the market.

Another practical concern is that commissions are built into financial products and cannot be removed without some cost to product manufacturers. Indeed, the many types of remuneration that skew incentives to the adviser (including upfront commissions, trailing commissions, soft-dollar incentives, volume bonuses, sales target rewards, fees based on percentage of funds under advice) are symptomatic of the sales culture that drives the financial advice industry. Consequently, it is not practicable to expect the industry to expunge commissions and other similar arrangements itself. Given the significant negative externalities associated with commissions, prohibition is the responsible course for government.

Recommendations arising from the PJC Inquiry into Financial Products and Services include regulation to require financial planners have a fiduciary obligation to their clients and government consultation with industry to cease payments from product providers to financial planners. The PJC has not explicitly banned sales commissions and other incentives. Industry bodies are divided on whether a fiduciary duty would preclude such payments.

<sup>18</sup> Conflicted advice is not a problem unique to the Australian market. Bullard and O'Neal (2006) find that in the US mutual fund industry for instance, investors using advisers pay a double penalty – they are directed to more expensive fund options, on top of the fees paid to the adviser.

## 4 Policies to address competitive failures

An important goal of superannuation policy must be to ensure that the (mostly non-government) institutions that deliver the policy do so effectively and efficiently.

The period since 2005 has been an important test of a policy that relies on choice and competition, with regulatory controls focussed principally on disclosure. It is increasingly obvious that such a structure is not adequate to discipline the managers of superannuation funds, particularly those driven by the profit imperative.

Most members currently do not exercise the right to choose, and switching by a small minority of fund members is not translating into stronger competition on fees and performance. Large and persistent performance differentials between the retail and not-for-profit sectors continue.

The welfare costs of this failure are large, with reduced accumulations certain to harm retirement incomes, economic growth and the government's fiscal position.

Industry bodies representing retail funds and financial planners have advocated voluntary codes and charters as a solution. Others have suggested that the government form a national default superannuation fund.

There is certainly a sensible course between these extremes which utilises the innovation and flexibility of a pluralist system, whilst addressing the source of market failures in a targeted manner.

The factors shaping competition discussed above suggest that members/consumers can be divided into three segments:

- (i) passive consumers (the majority);
- (ii) consumers making active choices, with professional advice (a larger minority); and
- (iii) informed and independent consumers (a small minority).

The groups are not necessarily static over time. We would expect that individuals can and would transition between groups over the lifecycle. Such a shift may also be prompted by major events, such as the recent global financial crisis, that lead to greater financial awareness and engagement.

An important goal of policy is currently, and should continue to be, to facilitate the process of consumers becoming more active and independent. Indeed, financial literacy programs aim to transition all consumers towards the first category. However, it is acknowledged even by those responsible for such programs that they will take many years, if not decades, to have significant effect (see ASIC, 2009: 78-81).

In the meantime, while the overwhelming majority of members are either passive or reliant on advice, policy must address those needs rather than rely on an idealised view of competition.

The categorisation is intended to ensure policy is designed to support more efficient outcomes for all consumers, through recognition that each group has distinct policy needs. It is important to recognise that while each group has distinct needs, these needs are not in competition or conflict. Policies to address all three groups can be implemented without sacrifice or trade-off, and without undermining competition or the potential for innovation. In particular, our suggestions to serve passive consumers are intended to strengthen rather than replace competition. See Appendix A for ISN's policy framework – A Super Safety Net.

## 4.1 Passive consumers

Passive consumers need a system of simple, effective, efficient default funds and investment options. It is entirely appropriate that modern industrial awards contain default superannuation funds that are eligible to receive superannuation contributions when active choice is not exercised.

Default superannuation arrangements should, as far as possible, ensure the best interests of the consumer are protected. The selection of low cost industry superannuation funds as default funds has proved successful for active and inactive consumers.

The decision by the Australian Industrial Relations Commission (AIRC) to identify default superannuation funds within the new Modern Awards to be maintained by its successor Fair Work Australia (FWA) has been welcomed by employer and employee representatives.

The establishment and application of objective criteria for eligibility for a fund to act as a default fund could be considered. Criteria should include member representation, as this clearly predicts superior performance, and could also include caps on fees, the prohibition of entry and exit fees, commissions and measures to ensure that a no disadvantage test is met when any automatic transfer occurs when an employees' work status changes.

Finally, a comprehensive solution is needed to address continued account proliferation. The approach could be market-based, by ensuring fees on inactive accounts do not meet costs (thereby creating an incentive for funds to manage inactive accounts), or by having a 'consolidate by default' function when people move between workplaces.

## 4.2 Active consumers under advice

Active, advised consumers need principal-agent problems to be addressed, through regulation which ensures the remuneration model of advisers aligns their incentives with those of the client. Financial planners should be subject to a legal requirement to act in the best interests of their client. Financial planners should be prohibited from accepting any payments from product providers or fund managers, and from charging ongoing percentage based fees for advice.

Arrangements that amortise the costs of complex advice over several time periods must not result in the amount being paid being larger than an agreed time-based fee. Finally, to prevent ongoing revenues from inertia, members should be required to 'opt-in' annually to advice services by accepting in writing the terms of such an arrangement including annual charges in both dollar and percentage terms.

## 4.3 Active independent consumers

Active, independent consumers require stronger and more comprehensible disclosure and the removal of the vestiges of regulatory and commercial constraints on choice and portability. As already discussed (see Footnote 13), the regulators are making headway in relation to disclosure but important additional work remains to be done to present information in a way that is meaningful to super fund members.

In particular, improved official statistics on the costs of superannuation products – fees, commissions and other charges including on investment management – to match the recently released series on whole of fund net performance, would greatly aid transparency and direct comparison between funds.

Because of the long term nature of superannuation, products potentially remain in the market years after they are closed. These 'legacy' products often have prohibitive exit fees. Offending providers should be required to make undertakings to transfer consumers out of these products without disadvantage. While legacy products persist, official fee data should include a measure of the opportunity cost associated with such fee structures that limit choice, such as high exit fees.

# Appendix A

## ISN Superannuation Safety Net

Given the compulsory nature of super and its importance not only to the quality of retirement to individual workers but also to the economic future of Australia, the regulation of the distribution of super needs to effectively accommodate the actual competitive dynamics of the market.

Critically, the industry – which benefits from \$61 billion in annual employer contributions (APRA 2009) and taxpayer funded concessions worth \$25 billion a year (Treasury, 2008) – should act in the best interests of working Australians and seek to protect their interests, rather than profit from consumer inertia. Indeed, there is an expectation from the Australian community that this should be the case. The proposal to introduce a Superannuation Safety Net is based on the following:

- Superannuation is a creature of regulation and therefore regulatory change can have a substantial beneficial or deleterious effect on individual savings and aggregate national savings.
- The majority of consumers are passive and disengaged in their superannuation; for example nine in ten workers do not choose their own super fund and members excessively discount their future needs.
- The lack of consumer sovereignty has led to market failure that in the short to medium term can only be addressed through changing the regulatory settings.
- The regulatory framework can act as a proxy for consumer driven demand through simulating the behaviour of rational, informed and engaged consumers.
- The regulatory settings must ensure that the key driver of fund selection, whether for an individual or a workplace, is net performance, consistent with maximising final payouts for both engaged and disengaged consumers.
- Competition for informed consumers should be based on brand, performance, cost and/or other features typical of consumer markets.
- It is acknowledged disclosure is insufficient protection for consumers that are disengaged and tend to discount the future.

On this basis a Superannuation safety net is proposed consisting of:

- an extension of the existing system of workplace defaults with representative trustees through the industrial relations system;
- a requirement that financial advisers act in the best interests of their clients;
- a ban on payments of commissions and asset-based fees from product manufacturers to financial planners;
- the capacity for super funds to provide low cost intra-fund financial advice to their members which is in their 'best interests'; and
- a practical and equitable solution to lost super/inactive accounts.

### Default fund selection

1. Where workers do not choose their own fund it is important that net performance (investment performance less fees) is prioritised in selection of the workplace default fund.
2. Superannuation is deferred pay and therefore a condition of employment. ISN supports the inclusion of default funds in modern awards. The Fair Work Act provides for awards to be regularly reviewed to ensure they remain relevant. The first formal review, scheduled for 2014, not only provides an opportunity for Fair Work Australia to vary individual awards to include or remove particular funds, but would also allow a Full Bench of FWA to establish principles that would guide the Tribunal in dealing with nomination of default funds. Criteria could include that a nominated super fund:
  - a. Not pay commissions or ongoing advice fees to intermediaries.
  - b. Operates within specified regulated fee caps, including entry, exit and ongoing fees.
  - c. When contributions cease the employee remains a member of the default fund until he/she consolidates into a new active fund or is rolled into a suitable ERF.
  - d. The fund is of sufficient size and scale to effectively and efficiently provide services to members.
  - e. The fund has procedures in place for following up arrears in payments.
  - f. The fund has a representative trustee structure.
  - g. The fund holds an APRA RSE Licence.
3. Where an employer and union/employees have negotiated an enterprise agreement, the award provisions should be deemed to apply unless the agreement deals specifically with the issue of naming a default fund or funds. In addition, the above criteria should also apply as part of the consideration in determining the 'no disadvantage' test during certification.
4. In instances where employees are outside award coverage, the default funds selected by their employers should also meet the same objective criteria applied to default funds approved through awards.

### Introduction of a 'no disadvantage' test on flipping (for new and existing products)

1. Related to the default fund policy, ISN proposes that a 'no disadvantage' test be applied to the practice of 'flipping'.
2. Where a trustee wishes to shift a member from a corporate or wholesale arrangement into a personal super product, they must ensure that the member is not disadvantaged, irrespective of the powers provided to the trustee in the governing trust deed.

## “Best Interests” framework for financial advice

Introduction of a Best Interests Obligation for all Financial Advice

1. Corporations Law be amended to provide that all financial advisers be subject to a requirement to act in their client’s best interests.
2. The best interests obligation should replace the requirement for advice to have a reasonable basis (s945A). The key elements of this obligation should be:
  - a. It will be owed by an individual planner to his or her client.
  - b. The best interests obligation requires the planner to give clients their undivided loyalty, which means the financial planner must strive to avoid any actual or perceived conflict of interest.
  - c. The method of payment for financial advice must reflect the planner’s undivided loyalty to their client.
  - d. An individual adviser or a licensee cannot receive any payments from product providers or fund managers.
  - e. Payment for advice must be made by the client and would ideally be based on the amount of time or advice provided.
  - f. Where the client and adviser agree on an asset based fee, this must be approved in writing by the client at least annually.
  - g. The standard against which this obligation is measured is that of reasonable skill, care and diligence to be expected of an ordinary prudent person acting in the capacity of a professional adviser.
3. The best interests obligation would also impact the construction of approved product lists, which would need to include a variety of product types to meet all client needs.
4. The best interests obligation would apply to planners who are employed by a product provider, or who work for a practice which is a subsidiary or related party of a product provider.
5. ISN proposes a ban on all product providers, including superannuation trustees and their parent trustee companies, from offering commissions or other incentives to adviser groups to secure sales of the product. This ban includes all incentives, including soft dollar incentives, shelf fees and volume bonuses.
6. ISN proposes that clients should opt-in, on an annual basis and in writing to receive and pay for financial advice. This is typical in client-professional relationships and ensures that consumers are only paying for advice they desire and receive.
7. ISN proposes that as part of the structural adjustment of the industry, advice fees paid directly by the client should be tax deductible.

## Simple Advice to Super Fund Members

1. ISN supports the retention of regulatory measures which enable super trustees to provide advice to their existing members.

## Appendix B

### Information asymmetry and demand side competition

Markets are institutions that connect buyers and sellers.

In the idealised view, competition between participants on both sides of a market leads to the equalisation of prices for equivalent products and should also, over time, drive innovation and efficiency, resulting in lower prices for a given product or improved quality products for a given price. Competition for investment returns between capital providers should also result in instances of above average profits being reduced as new market entrants provide stronger competition.

However, there are a number of circumstances – market failures – in which these dynamics may be undermined.

The traditional focus of competition theory and policy has been on failures that develop on the *supply side* of the demand-supply relationship. In particular, it has long been recognised that markets with high barriers to entry may result in relatively stable oligopolies or monopolies, leading to reduced competition, especially on price, and higher profits for suppliers than would otherwise be expected.

This supply side emphasis is reflected in, for example, the role of competition authorities in approving mergers or acquisitions that might increase market concentration beyond acceptable levels.<sup>19</sup>

In recent decades, however, there has also been a growing awareness among researchers and policy-makers that competition is also fundamentally shaped by *demand side* influences, particularly when the demand is from retail consumers (as opposed to demand from businesses in wholesale markets).

The main theoretical change driving this shift is the relaxation of the traditional neoclassical assumptions of perfect information and rational decision-making.

Imperfect information and bounded rationality may affect all market participants. However, in practice evolutionary forces will ensure that suppliers to retail markets understand the costs, benefits and risks associated with their core activities in great detail – or quickly go out of business.

The same cannot be assumed for retail consumers, who will often face potentially complicated transactions without the necessary information or skills to evaluate them on an equal footing. Information asymmetry is the name given to an imbalance in the information or skills of market participants.

Important areas in which demand side competition theory has developed include how the decision-making of consumers is shaped by transaction or switching costs (including learning costs), their understanding of complicated products or pricing structures and behavioural factors such as risk aversion and myopia (excessive discounting of future costs and benefits).

An example of a demand-side effect is high exit costs on long term contracts, such as for utilities, telephony or financial products (including mortgages and superannuation). Even in markets with many suppliers, these pricing techniques will lead to inelastic firm specific demand curves for the group of consumers with such contracts, because this group of consumers will be relatively insensitive to discounting from other suppliers. This will allow a greater level of profitability for suppliers than one would expect was possible in a superficially ‘competitive’ market (Farrell and Klemperer, 2007).

---

<sup>19</sup> Concentration on the demand side is rarely an issue in retail markets. In wholesale markets, however, conditions of monopsony or oligopsony can develop in which large buyers wield considerable market power. Arguably the large supermarket chains have such a position in the Australian grocery market as dominant purchasers of groceries at the wholesale level.

Switching costs may also influence competition even if not strictly financial – they may also result from product characteristics which will lead to time-wasting or irritation. An example from the telephony market is not being able to port landline and mobile telephone numbers from one supplier to another. The inconvenience associated with informing many friends and associates that your telephone number is changing discourages consumers from switching. Researchers in the US estimate that enabling customers to take their phone number with them to another supplier results in a decline in costs for toll-free services of about 14 per cent (Viard, 2003, in Ennis and Heimler, 2004).

The impact of information asymmetries on competition is analogous to a switching cost, which varies depending on the starting knowledge of the consumer. For a consumer to search for options and evaluate them, involves a cost, especially if that involves development of new skills. Consumers with less information and relevant skills either have higher switching costs or face greater uncertainty, with a higher chance of a sub-optimal outcome and losses.

As a result, uninformed or apathetic consumers will tend to be less price elastic, like customers who face high exit fees. Ennis and Heimler (2004) argue that the aim of consumer protection policy is to shift uninformed customers onto the more price elastic demand curve of the informed.

Information economics and behavioural finance have changed the way markets are understood. The presence of a number of suppliers is no longer viewed as a guarantee of strong competition and productive efficiency. Regulators must closely examine the market, including on the demand side, to establish whether consumer protection is necessary.

## Appendix C

### Summary table – fees and returns

**Table 1. Net returns versus fees and commissions for 18 large super funds**

*Default or largest investment option over six financial years – 2004 to 2009 inclusive (simple average)*

Fund	Segment	FP/NFP	Net returns	Fees
AustralianSuper	Industry	NFP	7.42%	0.78%
UniSuper	Industry	NFP	7.25%	0.59%
First State Superannuation Scheme	Industry	NFP	6.70%	0.40%
Retail Employees Superannuation Trust	Industry	NFP	7.39%	0.75%
HESTA Super Fund	Industry	NFP	7.05%	0.87%
Sunsuper	Industry	NFP	6.92%	0.85%
Construction and Building Unions Superannuation	Industry	NFP	7.53%	0.99%
Health Super Fund	Industry	NFP	6.99%	0.85%
HOST-PLUS	Industry	NFP	7.27%	0.70%
MTAA Superannuation Fund	Industry	NFP	7.30%	0.72%
ASGARD Superannuation Account	Personal	FP	4.87%	2.48%
AMP Flexible Lifetime Super	Personal	FP	5.85%	2.38%
MLC MasterKey Superannuation	Personal	FP	4.67%	1.98%
Colonial First State - FirstChoice Personal Super	Personal	FP	3.93%	2.03%
AMP CustomSuper	Corporate	FP	6.00%	1.58%
AMP SignatureSuper	Corporate	FP	4.98%	1.38%
Integra Super (Corporate Division)	Corporate	FP	5.00%	1.17%
MLC MasterKey Business Super	Corporate	FP	4.76%	1.50%

Source: Rainmaker, *Custom Data Sets* (2008, 2009)

Assumptions: \$50,000 account balance, \$5,000 contributions (net of tax), mid-point in range of contributions fees charged (eg. if range is 0 – 5%, 2.5% fee is assumed).

## Sources

- APRA (Australian Prudential Regulatory Authority) (2007), *Insight Vol II*, APRA.  
Available: <http://www.apra.gov.au/insight/>
- APRA (Australian Prudential Regulatory Authority) (2009a), *Annual Superannuation Statistics 2008*, APRA.  
Available: <http://www.apra.gov.au/Statistics/Superannuation-Institutions-Statistics.cfm>
- APRA (Australian Prudential Regulatory Authority) (2009b), *Superannuation Fund-Level Publications*, APRA.  
Available: <http://www.apra.gov.au/Statistics/Superannuation-Fund-Level-Publications.cfm>
- ASIC (Australian Securities and Investments Commission) (2009), *PJC Inquiry into Financial Products and Services in Australia - Submission by the Australian Securities and Investments Commission*, ASIC.  
Available: [http://www.aph.gov.au/senate/committee/corporations\\_ctte/fps/submissions/sub378.pdf](http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub378.pdf)
- Bateman, H and Mitchell O.S. (2004), 'New evidence on pension plan design and administrative expenses: the Australian experience', *Journal of Pension Economics and Finance*, Volume 3, Issue 01, Mar 2004, pp 63-76
- Benartzi, S. and Thaler, R.H. (2007), 'Heuristics and Biases in Retirement Savings Behavior', *Journal of Economic Perspectives*, Vol 21, No 3, pp. 81-104.
- Bernheim, B.D. and Rangel A. (2008), 'Behavioural public economics' in Durlauf S.N. and Blume L.E., *The New Palgrave Dictionary of Economics*, 2<sup>nd</sup> Ed.
- Beshears, J., Choi, J.J., Laibson, D., and Madrian, B.C., (2009), 'How does simplified disclosure affect individuals' mutual fund choices?', *Working Papers*, Paper 14859, National Bureau of Economic Research.  
Available online: <http://www.nber.org/papers/w14859>
- Bryan, D., Ham, R., and Rafferty, M., (2008), *Fund Performance in the Australian Superannuation Industry July*, Australian Institute of Superannuation Trustees.  
Available online: [http://www.aist.asn.au/media/13070/wrcsuperannuationfundperformancefindings\\_final.pdf](http://www.aist.asn.au/media/13070/wrcsuperannuationfundperformancefindings_final.pdf)
- Bryan, D., Ham, R., Harmueller, P., Rafferty, M., and Yu, S. (2009 Forthcoming), *Winning by default? Testing for the relationship between fund flows and performance in the Australian superannuation industry*, Industry Super Network.
- Bullard, M. and O'Neal, E. (2006), *The Costs of Using a Broker to Select Mutual Funds*, University of Mississippi Law School, mimeo.
- ChantWest (2008), *Superannuation Industry – Fee Comparison Report*, ChantWest.  
Available: <http://www.chantwest.com.au/PDFFiles/Fee%20Comparison%20Report%20May08%20FINAL.pdf>
- Coleman, A., Esho, N. and Wong, M. (2003), 'The investment performance of Australian superannuation funds', *Working Paper 2003-02*, APRA (Australian Prudential Regulation Authority).
- Diamond, P. (2005), 'Pensions for an Aging Population', Conference paper - *IDEI Annual Conference*, Toulouse, November 2, 2005.
- Drew, M.E. and Stanford, J.D. (2003) 'Principal and Agent Problems in Superannuation Funds', Discussion Paper No. 142, March 2003, *Discussion papers in economics, finance and international competitiveness*, Queensland University of Technology. Available: [http://eprints.qut.edu.au/384/1/Drew\\_142.pdf](http://eprints.qut.edu.au/384/1/Drew_142.pdf)
- Ellis, K., Tobin, A. and Tracey, B. (2008) 'Investment Performance, Asset Allocation, and Expenses of Large Superannuation Funds', *Working Paper October 2008*, Australian Prudential Regulation Authority.  
Available: <http://www.apra.gov.au/Research/working-papers.cfm>
- Ennis, S. and Heimler, A. (2004) 'Promotion of Competition on the Demand Side', *Working Paper Series*, Social Science Research Network. Available: <http://ssrn.com/abstract=622722>

- Ernst & Young, 2008, *The super iceberg - What's beneath the surface of Choice?*, October 2008, Ernst & Young.  
Available: <http://www.ey.com/AU/en/Newsroom/News-releases/The-super-iceberg>
- Farrell, J. and Klemperer, P. (2007), 'Coordination and lock-in: competition with switching costs and network effects', *Handbook of Industrial Organization*, Volume 3, pp. 1967-2072.
- FPA (Financial Planning Association), (2009), 'FPA Board approves remuneration policy', *News*, 23 October 2009, FPA.  
Available online.
- Freeman, J.P. (2007), 'The Mutual Fund Distribution Expense Mess', *Journal of Corporation Law*, Vol. 32, Iss. 4; pp. 739-832.
- Fry, T., Heaney, R. and McKeown, W., (2007), 'Will investors change their superannuation fund given the choice?', *Accounting and Finance* Vol 47, pp 267–283
- Gerrans, P., Clark-Murphy, M., and Speelman, C.P. (2008), 'Retirement Savings Investment Strategy: Member Choices and Performance', *Financial Education, Retirement, Planning and Decisions Group FEMARC - Finance, Economics, Markets and Accounting Research Centre Working Paper*, School of Accounting, Finance and Economics, Edith Cowan University. Available: <http://www.business.ecu.edu.au/schools/afe/wps/papers/pdfs/wp0805pg.pdf>
- Gerrans, P (2009), *Member Investment Choice Response to the Global Financial Crisis*, AIST.
- Hicks, J.R. (1935), 'The Theory of Monopoly: A Survey', *Econometrica* Vol 3, pp. 1–20.
- IFSA (Investment and Financial Services Association), (2009), *IFSA's draft super charter: A new commitment to super members*, IFSA. Available online.
- Investment Trends (2009), *Planner Business Model Report October 2008*, Investment Trends, April.
- InvestorDaily, (17 September 2009), (Uribe, A.), 'Flipping phenomenon alive and well: survey Members not aware of the practice'. Available: <http://www.investordaily.com/cps/rde/xchg/id/style/7406.htm>
- JCCFS (Joint committee on corporations and financial services) (2009), *Joint committee on corporations and financial services - Reference: Financial products and services in Australia*, Hansard, CANBERRA.  
Available: [http://www.aph.gov.au/senate/committee/corporations\\_ctte/fps/index.htm](http://www.aph.gov.au/senate/committee/corporations_ctte/fps/index.htm)
- Knetsch, J. L., (1989), 'The endowment effect and evidence of nonreversible indifference curves', *American Economic Review* 79, 1277–1284.
- McNair-Ingenuity (2008), *Annual Superannuation Survey – report prepared for Association of Superannuation Funds, October 2008*, McNair-Ingenuity (unpublished).
- Mercer (2006), *Mercer 2006 financial literacy and retirement readiness study*, Mercer.  
Available: [http://www.mercerwealthsolutions.com.au/docs/MWS\\_FinLtSdy\\_4487.pdf](http://www.mercerwealthsolutions.com.au/docs/MWS_FinLtSdy_4487.pdf)
- Rainmaker (2009), *Custom data series*, Rainmaker (Unpublished).
- RiceWarner (2008), *Superannuation Fees Report 2008*, IFSA. Available: [http://www.ifsa.com.au/documents/2008\\_1218\\_FINAL%20RWA%20Superannuation%20Fees%20Report%202008.pdf](http://www.ifsa.com.au/documents/2008_1218_FINAL%20RWA%20Superannuation%20Fees%20Report%202008.pdf)
- RiceWarner (2009), *Value of IFFP Advice*, Commissioned by Industry Super Network.
- Roy Morgan (2009), *Superannuation & Wealth Management in Australia – An analysis of consumer behaviour, advice and fund performance*, Report 11, Roy Morgan Research.
- Senate Select Committee on Superannuation (2002) *Provisions of the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002*, Australian Parliament House. Available: [http://www.aph.gov.au/Senate/committee/superannuation\\_ctte/completed\\_inquiries/2002-04/choice02/report/contents.htm](http://www.aph.gov.au/Senate/committee/superannuation_ctte/completed_inquiries/2002-04/choice02/report/contents.htm)

- Sethi-Iyengar, S., G. Huberman and W. Jiang, (2004), 'How much choice is too much? Contributions to 401 (k) retirement plans', in: O. S. Mitchell and S. P. Utkus, eds., *Pension Design and Structure*, Oxford University Press, Oxford, pp 83–95.
- SMH (18 November 2009), (Collett, J.) 'Legacy of plague proportions'. Available: <http://www.smh.com.au/news/business/money/superannuation/legacy-of-plague-proportions/2009/11/17/1258219829651.html>
- SMH (19 July 2009), (Johnstone, E.) 'Super fees review urged to unmask the fund flippers'. Available: <http://www.smh.com.au/business/super-fees-review-urged-to-unmask-the-fund-flippers-20090719-dphp.html>
- Smith, A., (1776, Current edition 1937), *The Wealth of Nations*, Random house, USA.
- Thaler, R.H. and Benartzi, S. (2004), 'Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving', *Journal of Political Economy*, vol. 112, no. 1, pt. 2.
- Treasury (2009), *Submission to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into Financial Products and Services in Australia*, ASIC. Available: [http://www.aph.gov.au/senate/committee/corporations\\_ctte/fps/submissions/sub388.pdf](http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub388.pdf)
- Viard, B. (2003), 'Do switching costs make markets more or less competitive?: The case of 800-number portability', *Stanford Business School Research Paper No. 1771 (R1)*. Available: <http://ssrn.com/abstract=371921>
- Vickers, J. (1995), 'Concepts of Competition', *Oxford Economic Papers*, New Series, Vol. 47, No. 1, pp. 1-23.
- Wallis Inquiry (Financial System Inquiry) (1997), *Financial System Inquiry Final Report*, (Mr S. Wallis, Chairman), AGPS, Canberra. Available: <http://fsi.treasury.gov.au/content/publications.asp>





## Industry Super Network

MELBOURNE  
Level 31, Casselden Place  
2 Lonsdale Street  
MELBOURNE VIC 3000

SYDNEY  
Level 12  
44 Market Street  
SYDNEY NSW 2000

CANBERRA  
Level 3  
39 Brisbane Avenue  
BARTON ACT 2600

e: [info@industriysuper.com](mailto:info@industriysuper.com) w: [www.industriysuper.com](http://www.industriysuper.com)

ABN No 54 007 016 195 AFS Licence No 232514