MySuper consultation working group

Issues paper on Fees and costs

I have had over 30 years' experience in superannuation consulting, asset consulting and management. I qualified as an Actuary in 1975 and I am a Fellow of the Institute of Actuaries (London) and of the Institute of Actuaries of Australia. I have held senior roles within the consulting actuarial divisions of a number of Australian firms including Mercer Human Resource Consulting, Coopers & Lybrand and Buck Consultants. I have also been responsible for the provision of investment services, asset consultants support and the development of investment products for ING Investment Management.

I have also played an active role in the Institute of Actuaries of Australia through past membership of the Superannuation and Employee Benefits Practice Committee of the Institute and my current membership of the Benefits Projections Working Group.

I am concerned about specific aspects of the issues paper.

I am also concerned that it does not demonstrate a clear understanding of the operations of Australian superannuation funds. In particular I believe that there is some confusion between fees and costs charged to members and the expenses paid by the fund.

A superannuation fund must pay for the services that it uses. Either directly as a payment from the fund for these services or indirectly by as a payment to a third party that provides these services. In both situations the fund meets these expenses by payments from the fund to a third party.

The separate issue is how these expenses should be charged to the members. Regardless of how this is achieved, all of these expenses must be charged to members in some fashion. The expenses can be charged to members by a direct deduction from the members' accounts, by a charge against the investment earnings prior to the allocation of these earnings to members' accounts or by a charge against a reserve held in the fund.

It would appear that the principle question addressed by the Issue Paper is what fund expenses should be deducted directly from members' accounts and what fund expenses should be charged to members indirectly.

I recognise that with MySuper products, simplicity is seen as a desirable objective in itself. Therefore, there is an attraction to minimise the number of fees deducted from a member's account. However, the focus should be on the impact of fees and costs not on how they are charged to members (see page 1 and pages 3 to 5 of the enclosed "Way Forward").

Subject to frequency and calculation detail, the financial impact of allocating an investment expense of .5% of assets as:

(a) a fee of .5% of a member's average account balance deducted directly from a member's account,

is the same as

(b) a deduction of 0.5% from the rate of investment earnings allocated to a member's account.

In each case, the impact on the member's account reflects the actual expenses incurred on behalf of the member.

However, the financial impact of charging a fixed dollar expense directly to a member's account will be significantly different to deducting this expense (times the number of members) from total investment earnings prior to calculating the rate of investment return (or crediting rate) to be added to the members' accounts.

My comments on specific issues are set out below.

1. The paper indicates that it is appropriate for members to be individually charged for costs incurred because of the member's personal choice. The paper also states "There are a range of other fees that fall into this category such as withdrawal fees, buy and sell spreads, contribution splitting fees, family law fees etc. However, these fees may not be able to be demonstrably linked to a member's choice, and allowing these fees to be charged to members may erode the comparability objective of the MySuper product. Therefore, it may be more appropriate for these costs to be recovered as part of the fees that all members must pay."

   I do not understand the logic of this statement. I would have thought that all of these costs are directly related to the choices a member makes. If these costs are allocated to all members rather than the members who make these choices, comparison of the administration fees charged by different MySuper funds will be distorted by the proportion of members who make these choices and the frequency with which they make these choices.

   With respect to buy-sell spreads I recognise that new contributions do not necessarily incur buy costs if the contributions are used to pay for benefits paid from the fund. However, if, in a MySuper fund, the costs of buying new investments are spread over all members, the administration costs for a fund with large contribution levels relative to benefit payments (say a new fund) will be significantly different to a fund where the reverse is the case (say an old, mature fund), even if their day-to-day administration costs are the same. Any comparison of administration costs between these funds will be misleading. The costs of selling investments become relevant when a member takes a benefit or transfers to a choice product. Why should continuing members bear the costs of members who are not staying in the MySuper product?

   With the other costs mentioned I would have thought that they are directly related to the individual circumstances of a member. I will, however, accept an argument that the overall level of these costs in virtually all funds is a small part of the overall administration costs of a fund and that introducing specific costs to cover these events may be spurious equity, particularly if we take into account the additional costs relating to administering and explaining these costs.

2. Issue 1 - Exit and switching fees

   The paper states "They will not be able to be paid to the trustee in their personal capacity or to any other party, and consequently must be paid into the fund. This will remove an incentive for trustees to advise members to switch investment options."

   These sentences suggest some confusion. As I have stated previously, we need to clearly differentiate between how fees are charged to members and how expenses are paid by the fund. If a switching fee is deducted from a member's account, this has no bearing on how the fund pays for the additional costs incurred by the fund in rearranging the investments as a result of the switch in investments that occurs. I presume that the issue that is of concern is where a third party makes a profit on the amount they charge to the fund when a switch occurs. I do not believe that the intent would be to not allow the fund to pay an investment manager for any costs incurred in rearranging the investments as required.

   "Question 1.4

   "Are there any other types of transactional fees that should be permitted to be charged to MySuper members? If so, should they also be on a cost-recovery basis?"

   I presume that all costs incurred to support MySuper members should be charged in some way to MySuper members? Is the question being asked, "What other transactional fees should be charged to members by a specific charge against the members' accounts?"

3. Issue 2 – Investment fees

   There seems to be a misunderstanding of what a buy/sell differential is. My understanding is that the buy/sell differential is a member fee or cost charged against a "neutral" unit price to allow, approximately, for the transactional expense incurred by a Fund when buying and selling assets as the result of new member contributions or benefit payments or transfers between investment options. The Paper refers to transaction costs generated when the asset mix (presumably within one investment option) changes. It should be noted that these costs are not individually met by the buy-sell differential. These costs are deducted from the investment income generated by that investment option and reduce the investment return allocated to members.

   With respect to the transactional costs saved if contributions can be used to meet benefit payments, the issue is who should benefit from this? I think a good argument can be made that terminating members should not, and that the benefit should be passed on to continuing members through lower investment costs and higher net returns.

   There also seems to be some confusion in respect of the situation where costs are deducted from investment returns. In most funds, the investment costs (as determined by specified formulae) are deducted from the investment returns and the net investment return is added

to the member's accounts. In most funds, there is no specific charge to a member's accounts to meet investment costs. Is Question 2.2 asking should a specific charge be deducted from member's accounts to meet investment costs? In many cases however, some costs are deducted from investment funds (run by third parties) to meet the cost of a range of different services used by the fund (e.g. Trustee services for the investment fund). These costs are generally on a cost-recovery basis and are subject to predetermined formulae that can be made available to members. Is the issue whether or not this should be allowed?

4. Issue 3 – Performance fees

   I believe that it is inappropriate for there to be legislative control on how any investment fees are to be calculated other than an overall requirement that Trustees should be able to demonstrate that the fee basis is reasonable. I would accept that APRA could provide guidelines on how an appropriate performance fee should be structured and therefore, a Principles based approach is to be preferred. Issues that should be considered when establishing these principles would include:

   a. The base fee should allow the investment manager to cover its operating costs. A fee that is lower than this will put the investment manager's ability to provide appropriate investment services at risk.
   b. The performance component of the fee should be a reward for skill and not simply a reward for esoteric beta.
   c. There should be a claw back provision such that future outperformance should be used to offset past underperformance before the performance fee becomes payable.

5. Issue 4 – Fair and reasonable allocation of costs
   I don't think anyone will disagree with this in principle. However, one has to balance the equity achieved by following this principle and the costs associated with splitting the costs and allocating them to members' accounts.

6. Issue 5 – Fees in choice products

   I cannot see why there should be any constraints on Choice products. These products will vary widely and members will need to compare all aspects of these funds carefully when making a choice. Why should there be any constraints on one aspect of the design?

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