Insurance

and

Superannuation

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ISC Submission to the Wallis Inquiry

The ISC submission to the Wallis Inquiry into the Financial System proposes a new set of regulatory arrangements which are significantly differerent, intentionally evolutionary, flexible and practical. This article is the executive summary of the Commission's submission.

The ISC is pleased to have the opportunity to make a submission to the Financial System Inquiry. Current regulatory arrangements are imperfect, and the time is right for some change. The greatest scope for reform at present is in the area of retail investment advice, where there are presently significant gaps, overlaps and inconsistencies in the regulatory framework. Because forecasting beyond the medium term is hazardous, there is a case for holding an inquiry every 5 to 10 years.

A major purpose of regulatory reform should be to improve consistency and liberality in the rules, and to promote competition and innovation in the marketplace. Proposals for reform should have regard to international consistency (keeping in step with the rest of the world), industry peculiarities (accounting for institutional diversity), and adjustment costs (making sure that within the financial sector, the gain exceeds the pain).

Objectives of financial supervision

The objectives of financial supervision are stability, efficiency and consumer protection. Prudential supervision is aimed at stability; it encourages financial institutions to remain solvent and investment schemes to be well run. Liberality and consistency in the rules improve efficiency by fostering competition and innovation in the marketplace. Regulation of retail business conduct is intended to promote fair, open and honest dealing between companies and consumers.

Rationale of financial supervision

The justification for bank supervision is systemic risk (maintaining the stability of the financial system) and depositor protection (providing a safe haven for small savers). Systemic risk is of less concern in insurance and superannuation, but supervision - in the interests of both prudential security and fair trading - is required for three other basic reasons:

- market failure - insurance policyholders and superannuation members are seriously disadvantaged by the inadequate and unequal information available to them. They find it difficult to understand complex products and to 'shop around' for best value. They hand over their money in advance, but have to take it on trust that the company or fund will be around in the future to honour the payment as promised;
- public policy - Government policies in relation to retirement income, social security, taxation and national savings all work in one way or another to elevate the social importance, and justify the prudential protection, of long-term (insurance and superannuation) savings. For example, public confidence is crucial to maintaining the political legitimacy of compulsory superannuation; and
- community expectations - it is unlikely the community would tolerate any significant downgrading of the protection provided to their risk cover and lifetime savings: the loss of the family home or 'nest egg' because of a misunderstood insurance policy or an incompetent superannuation manager could be personally devastating for those involved. Over the years, the community has come to demand more rather than less protection against the mismanagement of their money.

Conceptual approaches to financial supervision

Conceptual approaches to financial supervision - such as the institutional versus functional dichotomy - are useful only up to a point. Policy making and financial supervision have to be practical; they do not start from a blank sheet of paper; they cannot capture an untidy marketplace in a neat set of boxes. The regulatory arrangements should be allowed to evolve in a measured manner; they should not be suddenly forced into a radically different 'brave new world'.

The ISC considers that the only sensible course for prudential supervision in Australia is the 'solo plus' approach, where 'solo' refers to specialised supervision of deposit takers, insurers and fund managers at the financial entity level (whether by separate agencies or divisions of the same agency), and 'plus' refers to an additional layer of supervision at the financial group or conglomerate level.

Specialised solo supervision continues to be appropriate because of institutional diversity. For example, banks and life offices are quite different because of their business practices, risks and competencies, quite apart from their regulatory treatment. Treating them differently for regulatory purposes accommodates this diversity, provides consumers with a choice, and is consistent with international practice.

ISC Profile

The ISC is a relatively young agency (formed in 1987), and a relatively small agency (around 500 staff). It is, however, second among the financial

regulators after the RBA in terms of the financial entities it supervises and the assets they manage:

- 120,400 superannuation funds ($244 billion in assets)
- 51 life companies ($124 billion in assets)
- 160 general insurers ($35 billion in assets).

There is a large overlap between life insurance and superannuation: $91 billion of superannuation assets (over 37 per cent of the total) is managed by life offices (over 73 per cent of their total). The superannuation and life insurance Acts are modern and relevant, being introduced in 1993 and 1995 respectively, with substantial industry input.

Key market developments

In the period following financial deregulation, market developments with a particular relevance for the regulatory framework have included:

- the relatively rapid growth of superannuation, and of managed funds more generally. Some of this growth is attributable to rising asset values. Even so, it is clear that compulsory superannuation and other factors have resulted in household saving in the form of financial assets going more into managed funds (including life insurance and superannuation), and less into bank and NBFI deposits;
- blurring and convergence - major financial institutions are increasingly diversifying across industries (banking, insurance and funds management) and across national borders. Life offices have, for taxation and commercial reasons, moved into non-traditional products which are similar in some respects to term deposits (short-term capital guaranteed policies) or unit trust products (market linked policies). However, convergence is essentially a group (not entity) level phenomenon involving a relatively new breed of financial organisation: the international financial conglomerate;
- international coordination - the rise of the international financial conglomerate has been accompanied by increasing regulatory coordination through the peak international associations of banking supervisors (the Basle Committee), securities supervisors (IOSCO) and insurance supervisors (IAIS). This cooperative activity is being encouraged by the G7 Ministers, who see globalisation and technology as having increased international systemic risk;
- changing distribution systems - following the excesses of the late 1980's, the major banks and life offices have been forced to shift their competitive focus from size and market share per se, to price restraint and profitability. This has meant cutting their high cost distribution networks (of bank branches and life insurance agents), or else driving them harder through cross-selling arrangements. Along with this, a new financial advice industry has emerged; and
- specialised dispute resolution - complex financial products and inaccessible court processes have created pressure for industry-specific, alternative dispute resolution schemes in the financial sector. An array of specialised schemes have evolved which now provide consumers with convenient, informal, fast and low cost access to justice.

Overlaps in prudential supervision

The significance for policy making purposes of 'product blurring' (ie. financial entities writing non-traditional business on balance sheet) is very minor. There are no statutory restrictions in Australia on suitably structured financial groups conducting bancassurance and funds management, and 'blurring' and 'convergence' are therefore issues for conglomerate supervision, not solo supervision. However, there are three other notable areas where the present systems of prudential supervision overlap:

- superannuation - within the ISC, the life insurance group and superannuation group share a common interest in the prudent management of the $90 billion plus of superannuation assets held in statutory funds. While the solvency of the life company and the prudent conduct of the superannuation trustee can be regarded as separate matters, there is a synergy to be gained from a joint approach to the overall soundness of the life office/approved trustee combination;
- managed funds - the regulatory arrangements have driven a wedge into the managed funds industry, which falls under the ISC's SIS regime in respect of retail funds which qualify for superannuation status, and the ASC's collective investment regime for those which do not. The current split is commercially costly, but helps maintain the risk spectrum (which is desirable on general economic efficiency grounds). Moving unit trusts to the ISC would compress the risk spectrum, but the community may expect or demand this. Moving superannuation to the ASC could remove one inconsistency, but would worsen the life office/superannuation overlap mentioned above;
- deposit taking - the regulation of financial intermediaries, broadly defined, is split between the RBA (banks), ASC (merchant banks, finance companies) and AFIC/States (building societies, credit unions). There could be potential efficiency gains involved if the States were disposed to hand over their NBFIs to the Commonwealth.

At present, the coordination of financial supervision - including in respect of financial conglomerates - is undertaken on a non-statutory basis by the Council

of Financial Supervisors. The ISC considers that the Council works well in practice, but accepts that it has a low profile and limited powers. There could be a case for upgrading the Council by giving it a statutory mandate and additional responsibilities.

International experience

The ISC has drawn the following conclusions from its observation of international practice and debate.

First, the UK 'twin peaks' proposal of Michael Taylor - for a single systemic/prudential regulator and a single conduct of business regulator - would split the ISC: insurance would go to the bank supervisor; superannuation would go to the ASC. A variation of this would be the South African model of a single supervisor for the non-banking sector, which would see the ISC merging with the ASC in toto.

The ISC considers both variations to be highly problematic in an Australian context. Splitting the ISC would create a new life office/superannuation overlap. Merging most or all of the ISC into the ASC would create a large and unwieldy organisation which would be internally fragmented by its multi-functional mandate, its conflicting cultures and competencies, and its mixture of Commonwealth and State based powers and structures.

Second, the New Zealand approach of minimal insurance regulation is not considered relevant because of: the high degree of foreign ownership of NZ insurers (which effectively shifts responsibility to home country supervisors, such as the ISC); the very small size of the local NZ market; and growing scepticism in the international literature about prudential supervision relying solely on disclosure and ratings in a period when complex financial transactions (eg derivatives trading) can create massive exposures overnight.

Third, international experience with mega-supervision, eg in Nordic countries, does not provide any clear evidence of major economies of scale or scope. Rather, the impression is that solo supervision continues to be conducted by separate divisions (albeit under the one roof), and that coordination tensions are internalised but not eliminated.

Option - a lead supervisor model

One option for prudential supervision would be to let the current system - of specialised solo supervision plus a layer of group supervision - continue to evolve along its present course, albeit with some adjustments. While each model has its pros and cons, and none is perfect, the ISC would on balance favour this approach because it is evolutionary and consistent with the international direction being taken by the Joint Forum on the supervision of international financial conglomerates.

A refined 'solo plus' model would involve formal arrangements for a 'lead supervisor', and could be based on the following key elements:

- the RBA would be kept intact, because of the synergies between central banking and bank supervision, and because of its overall responsibility for systemic stability. If the States agreed, the RBA would also supervise the non-bank financial intermediaries given the efficiencies to be gained from removing the Commonwealth/State overlap in the regulation of operationally similar institutions. Finding the best home for friendly society supervision requires further consideration;
- the ISC would prudentially supervise (life and general) insurance and managed funds including superannuation (and standard unit trusts if a wider risk spectrum is forgone), to account for life office superannuation, to minimise inconsistency in the regulation of market linked savings products, and to preserve its specialised expertise in insurance supervision;
- the RBA and ISC would concentrate on the core functions of prudential supervision under an upgraded Council of Financial Supervisors (and have no consumer protection role). In regard to bancassurance groups, the RBA would be lead supervisor except where the life office is dominant and the bank is small (in which case the ISC would be lead supervisor), and group supervisory arrangements would continue to evolve in line with international developments; and
- consumer protection - eg. the regulation of product disclosure and financial advice - would be separated from prudential supervision and consolidated in a new Retail Investment Commission (see below).

Option - a mega-supervisor model

The ISC does not favour a single prudential (mega) supervisor; but if this model were adopted, the ISC nonetheless believes it could be made to work effectively in practice. This option would involve merging the ISC, AFIC/SSAs and possibly parts of the ASC into the RBA. The ISC is strongly opposed to the separation of central banking and bank supervision, and would therefore see central banking remaining within the mega-supervisor.

The major arguments against a mega-supervisor are: the inevitable initial clashes between different cultures and skill sets and the likely loss (over time) of the institutional memory and expertise of the subsumed regulators; community perceptions of prudential regulation and protection being the same for all products (irrespective of whether they are risk or savings, capital guaranteed or market

linked); and, the danger of a large, bureaucratic, cumbersome and insular organisation having too much power and too little accountability (eg. resulting in financial supervision which is less practitioner based).

Overlaps and options in consumer protection

There are clearly overlaps in consumer protection applying to financial services, both at the Commonwealth level, and as between the Commonwealth and the States. The ISC accepts that duplication and inconsistency - in the regulation of business conduct for fair trading purposes - can create unnecessary customer confusion, excessive compliance costs, and unfair competitive inequalities.

The current consumer protection regime is not only too fragmented, but in a number of areas it arguably has an overly prescriptive or 'black letter' style.

The ISC submission has outlined in some detail the current regulatory arrangements in relation to the three broad areas of: financial advice, product disclosure and complaints handling. Reference is made to an ASC/ISC harmonisation exercise, under the auspices of the CFS, which is making considerable progress in relation to common standards for the regulation of sales conduct.

However, three issues in particular remain outstanding: different regimes for licensing advisers; multiple rules for product disclosure; and the overlap between financial sector specific consumer protection at the Commonwealth level on the one hand, and the fair trading regimes of the ACCC and the States on the other.

The two main options for practical reform are: first, continuation of the present process of incremental, inter-agency harmonisation (particularly by the ASC and ISC); and second, consolidation of consumer protection measures into a single regime under one roof (whether the ACCC, ASC, or a new special purpose agency). While each approach has advantages and disadvantages, the ISC on balance has concluded that:

- a greater degree and faster pace of harmonisation could be achieved with a single regime administered by a single regulator. However, it should be noted that internalising tensions does not automatically resolve them - much work would still need to be done in relation to the licensing and supervision of financial advisers, in particular;
- financial sector specific consumer protection is preferable to the generic regimes of the ACCC and the States, because of the high degree of complexity in financial products, and the importance of not compromising the prudential security of the financial product providers. Therefore, financial products should be exempted from ACCC and State legislation, particularly section 52 of the Trade Practices Act (TPA);
- a new special purpose agency - a variation on the UK Personal Investment Authority model - would have a clearer mandate and sharper focus as the consumer protection regulator than the ASC, which is already a multi-purpose regulator with a very broad focus (encompassing economy wide company regulation and market integrity). Although a new agency would mean an extra regulator, it would more importantly result in fewer regulatory regimes; and
- external complaints handling schemes should continue to be industry based, to exploit specialised expertise, to provide maximum flexibility, and to encourage voluntary compliance.

A new Retail Investment Commission

The ISC proposes the establishment of a new Retail Investment Commission (RIC), to be the sole retail conduct of business regulator for financial advice, product disclosure and complaints handling in relation to savings products, and quite possibly risk products.

The RIC would be a statutory authority lying outside the Public Service Act, but within the Treasury portfolio and Council of Financial Supervisors. It would be funded by levies on product providers and financial advisers. There would be a board with equal representation from financial regulators, product providers, financial advisers and consumer groups.

The broad mandate of the RIC would be to regulate product providers and financial advisers for fair, open and honest conduct in the sale of savings products to retail customers. In doing so, the RIC would be required to have regard to the need for the prudential security of product providers, consistency and liberality in the rules, and competition and innovation in the marketplace.

The products falling within the RIC's (consumer protection) jurisdiction would include bank and NBFI deposits, life insurance policies with an investment element, retail superannuation, unit trusts and other retail securities. There would be a strong case for also including pure risk insurance (eg. term life and general insurance) products and general insurance brokers; this would need to be determined.

The RIC would seek, to the extent practicable, to shift the regulation of financial advice and product disclosure from a rules based approach to a less prescriptive approach based on broad principles and self-regulation.

The ISC's preferred model for the regulation of the financial system is set out (in a simplified form) in the attached table.

Mergers among financial majors

The ISC has a minimal role in competition regulation per se (the ACCC being the regulator in this area), but as a financial regulator does have a legitimate interest in broader questions of competition and efficiency across the financial sector, and would make the following observations:

- there is already considerable concentration in domestic retail financial services, with the top four banks accounting for more than two thirds of the banking sector, and the top three life offices accounting for more than half of the life insurance sector. Taking a wider view, the top four banking groups account for more than one third of the entire financial system;
- there is little or no support in the international literature for economies of scale in very large banks. However, there is no a priori reason for ruling out the possibility of economies of scale in insurance, and there is some likelihood of economies of scale in funds management;
- in terms of international competitiveness, the 'critical mass' and 'national champion' arguments have little intellectual rigour or economic credibility. Australian financial institutions wishing to diversify internationally already have the option of taking over, or otherwise linking up with, local companies in foreign markets; and
- the current regulatory framework - whereby the ACCC administers section 50 of the TPA, and the Treasurer has the discretion under banking, insurance and foreign investment legislation to reject a proposal, having regard to special public interest considerations applying in the circumstances at the time - works well in practice, and is appropriate for the future. It should be noted that the Treasurer's power to reject proposals needs to be retained for prudential supervision purposes (eg. 'fit and proper' considerations).

Electronic commerce

Forecasting the speed and manner with which the market will take up technological developments is notoriously difficult. The ISC does not 'crystal ball gaze', and is not proposing to speculate on the future shape or appropriate regulation of the payments system. The ISC's interests in technological and market developments in electronic commerce are presently:

- to maximise the electronic delivery of (and thereby reduce the compliance cost of) the statutory returns which insurance companies and superannuation funds are required to provide to the ISC under its prudential regimes;
- to monitor the commercial use of electronic networks (including the Internet), particularly in relation to the application of disclosure rules to direct marketing. For example, ISC product disclosure rules require that a Key Features Statement is included in sales material;
- to facilitate industry initiatives - such as the 'transfer protocol' - to streamline transfers of superannuation benefits between funds; and
- to monitor the local distribution of unregulated insurance products provided by unauthorised foreign insurers. If this practice were to become widespread and problematic, an internationally coordinated regulatory response could be required.

ISC's preferred model for the regulation of the financial system

Focus	Regulator	Coverage	Nature of Regulation
Systemic Risk Prudential supervision of deposit taking financial institutions	Reserve Bank of Australia (RBA)	Banks Building Societies Credit Unions	Institutional
Other Prudential Supervision	Insurance and Superannuation Commission (ISC)	General insurance companies Life insurance companies Superannuation entities[1] Collective Investments[2]	Institutional Institutional and Functional
Retail Business Conduct	Retail Investment Commission (RIC)	Conduct of product providers and advisers in respect of: - financial advice; - disclosure; - complaints handling; Oversight of complaints handling schemes	Functional
Market Integrity and Companies	Australian Securities Commission (ASC)	Companies Exchanges	Functional
Competition	Australian Competition and Consumer Commission (ACCC)	Competition Generic Consumer Protection (excluding financial sector)	Functional

Notes: 1. Including supervision of retirement income standards of superannuation entities and functional supervision of RSAs.
2. If prudentially supervised.

Trustee disqualification - an AAT casestudy

A recent Administrative Appeals Tribunal (AAT) decision endorsed the Insurance and Superannuation Commissioner's strict enforcement of the extremely high standards of honesty required of persons and corporations seeking to become trustees.

On 11 September 1996, the AAT upheld the Insurance and Superannuation Commissioner's (the Commissioner) decision not to waive the disqualified person status of an executive chairman of two trustee companies. The trustee companies are responsible for several hundreds of millions of dollars in superannuation monies.

Under the Superannuation Industry (Supervision) Act 1993 ('SIS Act') a person who has been convicted of an offence in respect of dishonest conduct, in Australia or overseas, is disqualified from being a trustee or a director, secretary or executive officer of a corporate trustee of a superannuation entity. A disqualified person can take no part in the management of a corporate trustee.

Any conviction, no matter how long ago it happened, is caught by the SIS Act. The SIS Act even catches offenders discharged without conviction where the charges were found to be proven (eg were an offender is placed on a good behaviour bond).

A disqualified person may apply to the ISC for waiver of their disqualified person status. The ISC has a discretion to waive their disqualified person status if he is satisfied that 'the applicant is *highly unlikely* to be a prudential risk to any superannuation entity'.

The executive chairman applied to the ISC to have his disqualified person status waived. He had been convicted in the UK of submitting fraudulent insurance claims. The convictions took place 27 years ago when the person was 21 years of age and backpacking around Europe with some friends. The amount involved in the fraudulent claims was the equivalent, in present values, of just over $2000.

The Commissioner decided not to exercise his discretion to waive the persons disqualified person status. As a result the person applied to the AAT for review of the decision.

The AAT upheld the Commissioner's decision and said that "the SIS Act provides for extremely high standards of honesty to be applied to persons and corporations seeking to become trustees". It noted that the test to be applied by the ISC when considering applications for waiver was a demanding one. The disqualified person must not only be unlikely to pose any prudential risk superannuation entities, but be *highly* unlikely to do so. The AAT then said that: "It is clearly desirable that, in the context of a person or corporation acting as trustee, such high standards should not only be expected but strictly enforced".

The AAT found that the executive chairman failed to meet this demanding test as he had not, as fully and promptly as he could have, informed the ISC of the circumstances surrounding the facts leading to his convictions. In fact, it was only whilst in the witness box during the AAT hearing that the executive chairman revealed that there had been a conspiracy between himself and his friends to submit fraudulent claims to two insurance companies after returning from their backpacking trip, regardless of incurring any claimable losses.

The AAT considered that in the light of the seriousness of any offence of fraud, the fact that the executive chairman had not been open and honest at the earliest opportunity to both the ISC and the AAT, reflected on the 'wisdom, 'good judgment', 'forethought', and 'deliberation' which the chairman had applied to his situation and raised a substantial doubt as to how those qualities may be exercised in relation to decisions made with respect to superannuation entities for which he was responsible.

The disqualification provisions apply to all trustees, whether they be approved trustees of public offer superannuation entities, or trustees of 'mum and dad' type superannuation funds.

Actuarial Advisory Committee update

In announcing the introduction of a superannuation surcharge for high income earners in the Commonwealth budget on 20 August, the Treasurer established an Actuarial Advisory Committee to report on the application of the surcharge to defined benefit schemes and to unfunded and Constitutionally protected schemes. This article provides an update of the Committee's progress.

In this year's budget, the Government introduced a superannuation surcharge for employer contributions paid to high income earners. The surcharge will be phased in by increasing the rate of tax payable on employer contributions by one per cent for every additional thousand dollars of annual income, commencing when annual income exceeds $70 000 pa up to a maximum of $85 000 pa.

Recognising the special position of defined benefit funds, where a significant proportion of the employer contribution may not be paid in regular annual instalments, the Treasurer has referred the application and administration of the surcharge as it applies to these funds to an Actuarial Advisory Committee chaired by Craig Thorburn, the Australian Government Actuary.

The Treasurer has also nominated Professor David Knox from the University of Melbourne. Other members will include two members nominated by the Institute of Actuaries of Australia.

The Committee was able to convene shortly after the budget recognising the requirement to report by 31 October provided limited time. Clearly, the recommendations of the Committee will need to be considered by the Treasurer and the results need to be announced as soon as practicable so that the time available before implementation is as long as possible.

The Committee has spent the first month in three main activities: fact finding; communication; and analysis.

Fact finding and *communication* - The Committee has invited submissions, which close on 27 September, and has met with a number of interested industry representatives both formally and informally. Meetings have also been held with interested groups and other stakeholders.

Analysis - While several proposals and options are under active consideration, development of these options have played a key role in helping to understand the features of the surcharge and appreciate some the relative advantages and disadvantages of suggested strategy.

At the time of writing, with a week to go before submissions are to be received, four short submissions have been received. Two are from members of funds and two are from fund secretaries.

Should any reader wish to discuss the work of the Actuarial Advisory Committee they are invited to contact the Australian Government Actuary directly.

Few observers consider that the issues passed to the committee are anything other than complex. As a result, few suggested solutions have been aired. However, this probably reflects the likelihood that pages of symbols and algebra would possibly shed little light on the matter.

The terms of reference for the committee are set out below.

Terms of reference

The Government is seeking the advice of the Committee, by 31 October 1996, on the application of the superannuation contributions surcharge for higher income earners to defined benefit schemes and unfunded and Constitutionally protected schemes, including the development of equitable mechanisms for:

- determining appropriate contribution rates for defined benefit funds for the purpose of applying the surcharge;
- ensuring any changes in defined benefits which arise from the surcharge relate only to benefits accruing after 20 August 1996 and impact only on those members of the defined benefit fund who are liable for the surcharge; and
- achieving an appropriate tax treatment of unfunded and Constitutionally protected schemes, which impact only on benefits accruing after 20 August 1996 in respect of those members of the scheme who are liable for the surcharge and equilibrates the position of high income earners in such schemes to the application of the surcharge (these tax issues are to be progressed in consultation with Treasury and the Australian Taxation Office).

The restructuring superannuation industry

The superannuation industry has continued to restructure during the first year of operation under the SIS Act, resulting in an industry that is increasingly polarised. In this article we review recent structural changes that have occurred in the concentration of the superannuation industry and examine many of the recent trends that have been revealed from the 1994-95 ISC annual returns and the ISC Quarterly Survey of Superannuation.

Growth in number of funds

There are now in the order of 135 000 superannuation funds in Australia, up from 109 000 in June 1995. This represents an annual increase of 24 per cent, or over 2 000 new funds per month during 1994-95. However when analysing this growth it is important to note that while the overall number of funds is increasing, the number of large funds is actually decreasing. That is, only small funds are increasing in number.

For example, during 1994-95, excluded funds grew in number from 75 500 to 104 000 (up 38 per cent). At the same time, non-excluded funds decreased from 7 800 to 5 300 (down 32 per cent). While the decline in the number of non-excluded funds, as shown below in figure 1, was largely in line with previous trends, the growth in the number of excluded funds was considerably above the expected trend.

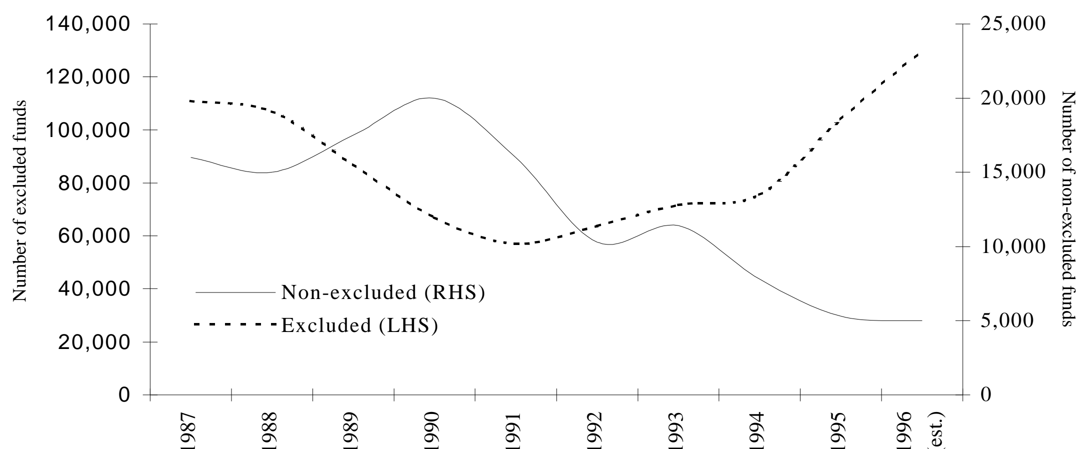
The different trends in the number of small and large funds therefore suggest that there are fundamentally different pressures impacting upon these respective market segments.

It also appears that many funds may have reviewed their overall position in the market with the introduction of the SIS Act and taken the opportunity to restructure themselves. The likelihood that the reduction in the number of non-excluded superannuation funds has been primarily due to small and medium sized corporate funds rolling into larger funds (eg mastertrusts and industry funds) supports this view.

Further illustrating this, of the 7 800 non-excluded funds operating as at June 1994, by June 1995 34 per cent were operating as excluded funds. This implies that many medium sized employers have transferred their employees' superannuation accounts to larger funds eg industry funds, or possibly mastertrusts, while preserving the fund in an excluded form for their own personal use. A further 17 per cent of non-excluded funds were wound-up during 1994-95. These corporations that would have most likely transferred their superannuation arrangements into large retail funds (see figure 2).

Importantly, these dynamics have not generally increased the number of industry funds or mastertrusts, but rather increased their market share of assets and members. For example, industry funds now represent around six per cent of total superannuation assets, up from three per cent in June 1992. Mastertrusts now represent eight per cent of total superannuation assets, up from 4.5 per cent in June 1992.

Figure 1: Growth in the number of funds



Therefore, the rationalisation in small and medium sized corporate fund sector has contributed to industry funds and mastertrusts doubling their market share of assets in the last four years (see table 1).

Table 1: Asset growth by fund type

Fund type	Annualised Growth Rate #
Industry funds	35%
Mastertrusts	29%
Excluded funds	26%
Other retail funds	17%
Public sector funds	10%
Corporate funds	-1%

For period 1992 to 1996

However, while medium sized superannuation funds have been subject to rationalisation, larger superannuation funds have been more durable, possibly reflecting their more sophisticated and longer standing operations and the role of superannuation as a labour market tool for larger private sector employers. The small reduction in the number of large funds most likely reflects some consolidation of superannuation arrangements within large financial entities.

For example, a number of large employers and retail superannuation providers have rolled their separate regulated funds into a smaller number of larger regulated funds. Illustrating this, some approved trustees offering retail superannuation products now have a single regulated fund covering separate divisions of specialised products. For example a single regulated fund may contain one division for the mastertrust, while maintaining separate divisions for personal products.

The rationalisation of funds in the five to 200 membership range, see figure 3, has resulted in an increased concentration of funds, assets and members at the small and large ends of the industry, that is in both the excluded fund sector and in the large superannuation funds sector. Highlighting this restructuring, superannuation funds in the 5 to 200 member range have decreased their share of total superannuation fund assets from seven per cent in June 1993 to only two per cent in June 1995.

While excluded funds have dominated superannuation growth in terms of the number of funds, they have also increased their representation of total assets. As at June 1995, excluded funds represented 95 per cent of all superannuation funds and 11 per cent of all superannuation fund assets (up from 89 per cent and 6 per cent respectively in June 1993).

Figure 2: Corporate sector dynamics 1995-96

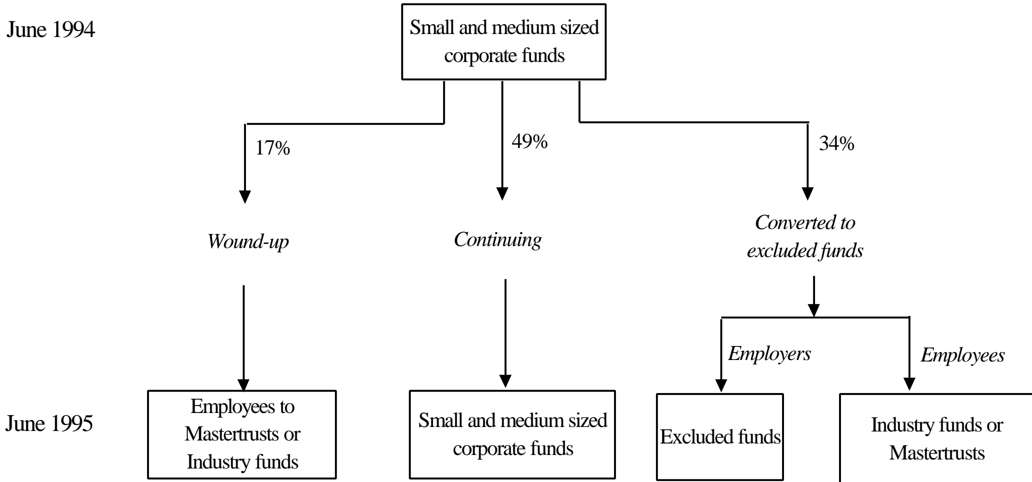
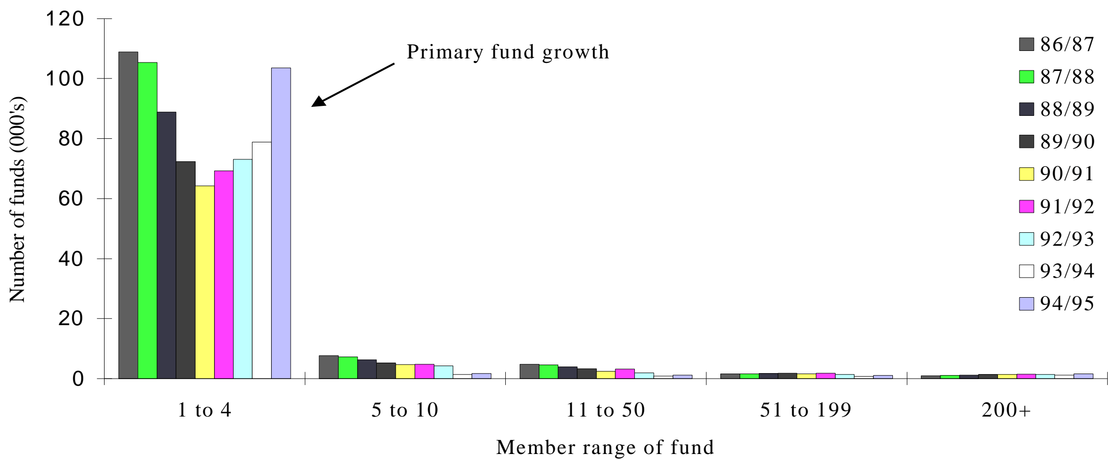


Figure 3:The number of funds 1986-95



Reflecting parallel but more modest increases, superannuation funds with more than 200 members in June 1995 represented 88 per cent of superannuation fund assets and 97 per cent of members (up from 87 per cent and 96 per cent respectively in June 1993).

Therefore the superannuation dynamics of recent years have essentially seen polarisation of the industry into two quite distinct segments, namely, the very small funds and the very large funds. These two distinct segments now represent the overwhelming majority of the superannuation industry.

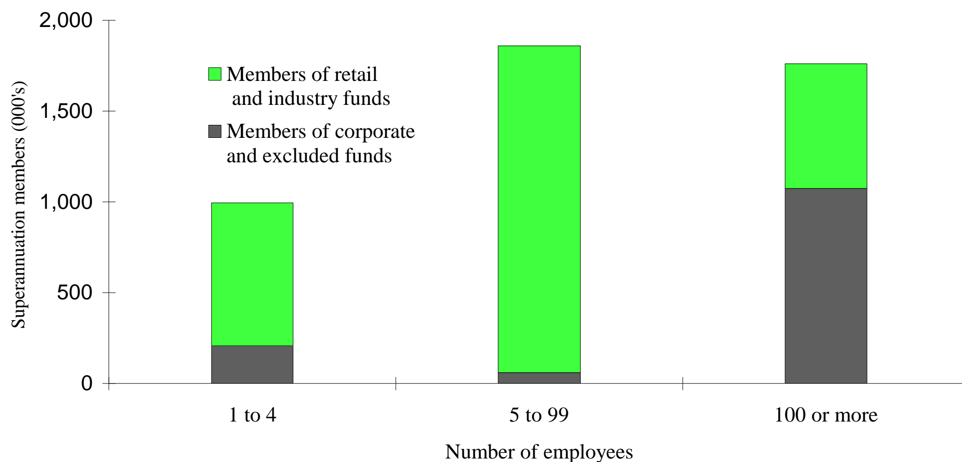
Corporate superannuation coverage[1]

At June 1995, there were 175 000 private sector businesses in Australia employing more than five employees[2]. At the same time, there were only around 4 600 corporate superannuation funds. Therefore, only three per cent of these businesses operated their own superannuation fund. This suggest that the remaining 97 per cent of businesses, to satisfy SG obligations, directed employer contributions into industry funds or retail funds (eg mastertrusts).

However the likelihood of a business operating their own superannuation fund appears to vary significantly with the size of the business. Medium size businesses (five to 100 employees) tend to utilise mastertrusts or industry funds, while large businesses (more than 100 employees) have a greater tendency to operate their own superannuation fund.

For example, even though around 25 per cent of total private sector workers are members of a superannuation fund operated by their employer, only three per cent of employees in medium size businesses are members of a superannuation fund operated by their employer, compared to 61 per cent of employees of large businesses (see figure 4).

Figure 4: The structure of the private sector superannuation market



Excluded funds

While a minor part of the growth in the excluded fund sector can be explained by small corporate funds converting to excluded funds, a more significant proportion of excluded fund growth has been due to high net worth individuals opting out of their current employer sponsored superannuation fund and directing contributions into their own personally managed excluded fund.

The growth in the number of excluded funds during 1994-95 by far outstripped the growth in very small businesses (ie businesses with less than five employees). For example, during 1994-95 the number of very small businesses decreased by 0.2 per cent while the number of excluded funds increased by 30 per cent. This suggests a very limited relationship between small business growth and excluded fund growth.

Further reinforcing this, as at June 1995 there were around 750 000 very small businesses but only 104 000 excluded funds. Complicating this analysis however, is the fact that only 36 per cent of employers[4], including small business operators, are covered by superannuation. These small business operators are the only sector in which superannuation coverage has actually decreased in recent years.

Another important influence in the growth in the excluded funds sector is the increasing use of excluded funds to satisfy post retirement income needs. For example, around half of all excluded funds set up after 30 June 1995 elected to be regulated under SIS under the ‘old-age pensions’ power of the Constitution (compared to 37 per cent of excluded funds established prior to 30 June 1995). This could suggest that the ‘old-age pensions’ power route is more cost-effective than the ‘corporations’ power route for some excluded funds, as a corporate trustee would not need to be established.

Inactive accounts

Different types of funds also tend to have different levels of inactive accounts. The most noticeable point is that retail and industry funds have a considerably higher rate of inactive accounts (38 per cent and 29 per cent respectively) than corporate funds (nine per cent).

The relatively low level of inactive accounts for corporate funds, however, most likely reflects members’ close ties to the employer and hence improved ability to monitor employee turnover more efficiently than industry or retail funds. Moreover, anecdotal evidence suggests that employers are very reluctant to retain a member in their corporate fund after the employee has left the company. This is also supported by the fact that the overwhelming majority of members of corporate funds are employees of large business, a sector that would have more sophisticated employee record systems.

The relatively higher level of inactive accounts in industry and retail funds partly reflects the higher employment turnover in smaller businesses, which predominantly use retail and industry funds. It also reflects the more complex lines of communication between the superannuation member, employer and fund administrator in industry and retail funds compared to corporate funds.

The relatively high level of inactive accounts in some sectors may change in the future as a consequence of member protection legislation, increased use of Eligible Rollover Funds (ERFs) and the new arrangements for lost member moneys administered by the Australian Tax Office from October 1996.

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1 This analysis focuses on the private sector on the assumption that all public sector works are covered by the relevant public sector employer sponsored fund.

2 Small Business in Australia, ABS Catalogue No. 1321.0

4 Superannuation Australia, November 1995, ABS Catalogue No. 6319

Member investment choice - latest analysis

Through investment choice, superannuation fund members can now have a greater say in how their superannuation savings are managed. In this article we review the extent to which investment choice has been implemented across the superannuation industry.

Traditionally, superannuation fund members have relied upon their fund's trustees to make all the investment decisions of the fund. However, recognising that funds contain people of differing ages, financial needs and attitudes to investment risk, the Government has permitted - but not required - superannuation funds to establish investment strategy choices for members who would like a greater say in how their superannuation savings are managed.

Superannuation fund members have investment choice when the fund trustees offer them a choice of strategies for how their superannuation savings will be broadly invested. The range and structure of investment strategies offered are at the discretion of the fund's trustees (subject to the SIS legislation requirement that trustees formulate and adhere to investment strategies). Typical investment strategies may include a growth portfolio, a guaranteed or stable portfolio and a balanced portfolio.

A growth portfolio usually includes high exposure to equities, a guaranteed or stable portfolio usually includes high exposure to fixed interest securities, and a balanced portfolio usually includes a mixture of equities, fixed interest and property. If members do not actively make a choice, they will be assigned a default strategy, which is usually a balanced portfolio. Whatever strategies are offered by the trustee and however they are named, it is vital that the trustee properly disclose to members the risks and returns associated with each strategy.

Benefits of investment choice

Funds which offer investment choice allow members an opportunity to select one, or a combination of, predefined strategies in order to more closely match their particular superannuation goals and needs.

For example, younger members can increase the growth component of their superannuation savings in order to build a substantial savings base over time or older members can have their capital protected by choosing a more conservative strategy as they approach retirement. In this manner, members have more control in the accumulation of their retirement savings. In contrast, where there is only one common strategy offered by trustees, members do not have the opportunity to tailor their choice of strategies to suit their personal circumstances.

However, when considering whether and how member investment choice should be introduced, fund trustees need to weigh up several important factors, including the particular profiles and investment requirements of their members, implementation cost, member knowledge and sophistication, and fund administration capabilities.

Member education is an extremely important issue for funds offering member investment choice as trustees need to ensure that members understand the effect (and risk) involved in choosing a particular investment strategy over relevant time horizons. Without appropriate education, members will not be able to make an informed decision as to their investment requirements.

Overseas experience

In the United States, member investment choice is widespread because it is a standard feature of 401(k) pension funds, and because of the existence of a wide range of mutual funds. A 401(k) pension fund is a personal retirement plan, somewhat comparable to an individual excluded fund in Australia. Over 70 per cent of funds in the United States offer between three and five investment choices, with only 10 per cent of funds offering one or two choices[1].

The most widely available investment option is a growth option, with 90 per cent of US plans offering a domestic equity investment option. However, it does not automatically follow that the rate of take-up of growth options is as high, and the possibility of excessive investment in low risk, low return investments has been a major concern of many critics of investment choice.

Unlike the United States, investment choice in Australia presently remains limited to a relatively small number of funds, albeit funds which tend to be large in terms of assets and member accounts. Since these large funds manage the overwhelming majority of superannuation members and their savings, the 13 per cent of large funds that have already introduced investment choice account for nearly half (43 per cent) of all members. These figures are consistent with a survey conducted by ASFA in February 1995 which showed that around 17 per cent of ASFA member funds offered investment choice.

Experience to date has shown that retail funds are best placed to deal with the complexity of investment choice. Entry to these funds is usually via an investment unit or life policy product which can serve as a vehicle for accessing one or more of a number of underlying investment strategies. Typically, a retail product can be tailored to include

[1] Source: ASFA *Superfunds*, November 1995.

varying proportions from an equity strategy, a fixed interest strategy, a property strategy and so on, facilitating a wide range of investment choices. In this way, retail funds may be viewed as having a convenient structure for readily offering investment choice, whereas other fund types would have to introduce new arrangements to achieve investment choice.

Characteristics of funds that offer choice

Regulated superannuation funds are required to lodge an audited Annual Return with the ISC. In the 1994-95 Annual Return, all large funds were asked to indicate whether or not they offered member investment choice and, if so, to provide the number of investment choices available. Analysis of these statistics allows us to examine what types of funds offer investment choice.

From this analysis, it is clear that retail funds - for reasons outlined earlier - are much more likely to offer investment choice than other funds. In fact 46 per cent of retail funds, representing 83 per cent of retail assets and 86 per cent of retail member accounts, offered member investment choice in 1994-95. This compares to less than 10 per cent of funds in other sectors which offered choice in that year (see figure 1). A similar result was obtained from the 1995 ASFA survey. Of course, member choice of investment strategy may have spread more widely in the following year.

These results are what we would have intuitively expected, as one of the major attractions of retail superannuation funds is the wide choice of investment options provided by these funds.

The results also reflect the significant differences in how different fund types operate. For example, because many retail funds are really complex groupings of superannuation products (where the 'fund' is the legal umbrella entity that reports to government), it is not surprising that a high level of these funds offer investment choice. On the other hand, the low incidence in 1994-95 of investment choice for corporate, public sector and industry funds may simply reflect the more direct fund-to-member nature of these funds, which capture superannuation savings directly from their members rather than from product pools.

Reinforcing this, the small average member account balances of industry funds (only around $2,500 per member account in 1995) may suggest that there would be little demand at present by industry fund members for investment choice. This has been borne out by some industry funds who have commenced to offer member choice of investment strategies but which have had extremely low 'take up' rates.

In corporate and public sector funds the increased administrative cost of member investment choice, especially where the employer may already subsidise the operation of the superannuation fund, is a disincentive for offering investment choice. Moreover, the majority of defined benefit plans, for which member investment choice is essentially irrelevant, are found in these sectors.

Reflecting the fact that retail funds are often very large, the likelihood of a fund providing investment choice to its members increases with the asset size of the fund (see figure 2).

Figure 1 - Investment choice proportions by fund type, 1994-95

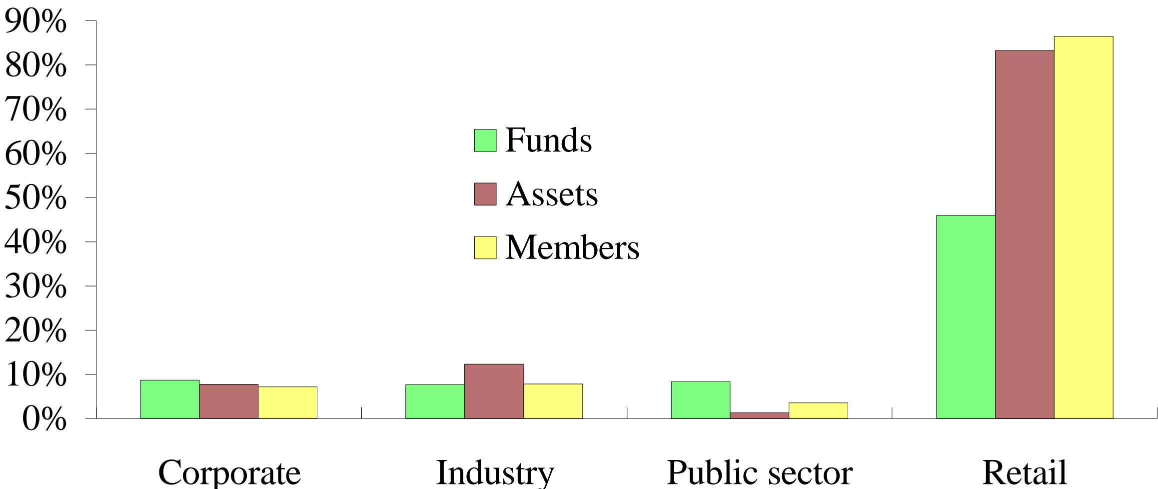
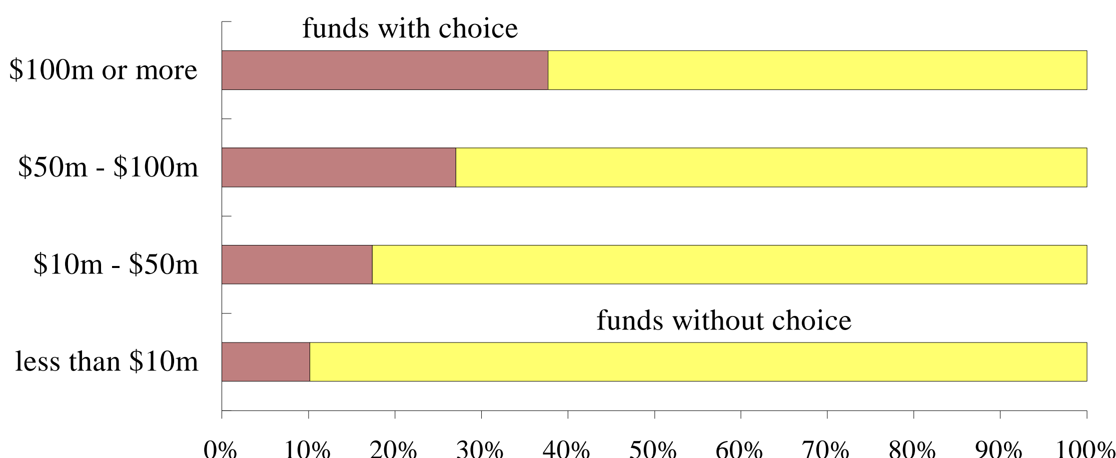


Figure 2 : Fund investment choice proportions by asset, 1994-95



The proportion of funds providing member investment choice increases steadily from 10 per cent for funds holding less than $10 million in assets, to 38 per cent for funds holding more than $100 million in assets. This suggests, as would be expected, that more diverse and sophisticated investment options become available as funds grow in size.

For example, as a fund's assets increase it can use its increased market power to take advantage of efficiencies in the investment markets by moving from the retail to the wholesale investment market, and then to individually mandated portfolios. Pursuing these overall strategies significantly simplifies the provision of member investment choice, with the costs of providing choice becoming proportionately less as the size of the fund increases. Larger funds can also achieve greater economies of scale in the administration infrastructure required to operate member investment choice.

It is also clear that member investment choice is significantly affected by the number of members in the fund. For example, only around 10 per cent of members from funds with fewer than 500 members have access to member investment choice, whilst 44 per cent of members of funds with more than 500 members have a choice. Particularly for funds with high individual member holdings, this suggests that economies of scale can be achieved by funds with large numbers of members. However, where funds with more than 500 members presently have a relatively small asset base (including many industry funds) investment choice has subsequently not yet been introduced. This result suggests that member investment choice is most effective for funds where there are sizeable member holdings. These large funds may also be better placed to offer effective member education programs that are necessary to support member investment choice.

This also reinforces the view that the administrative costs of introducing investment choice may be prohibitive for many medium sized funds. In fact, preliminary ISC analysis of unpublished data from the 1994-95 Annual Returns suggests that, on average, funds providing investment choice have 20 per cent higher administrative costs per member than funds that do not provide investment choice.

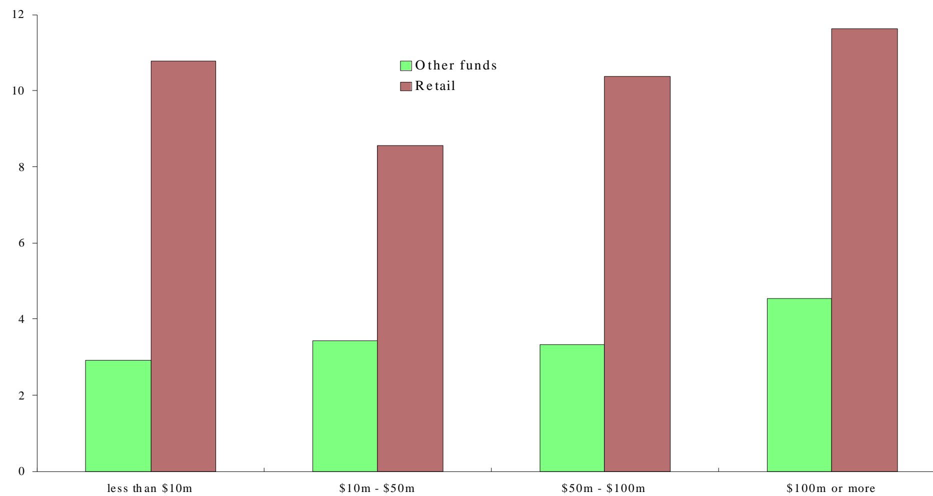
Importantly, member choice does not appear to be provided by utilising additional investment managers to oversee additional investment options. The average number of investment managers per fund is the same for funds providing investment choice as for funds not providing choice. This suggests that where investment choice is offered, the choices are often provided by the same investment manager(s). The actual investment options are then simply options for greater or lesser exposure to the particular asset classes that previously made up the balanced portfolio.

Number of investment choices

The number of investment choices offered also varies by fund type and asset size (see figure 3). Retail funds offering investment choice average 10 investment choices, reflecting the fact that each retail fund is really a grouping for compliance purposes of previously separate investment products. In contrast, corporate, industry and public sector funds offering investment choice average three choices, most likely a growth option, a capital stable option and a balanced option.

Figure 3 shows that the number of choices available increases with asset size, similarly to the manner in which the proportion of funds offering member investment choice increased with asset size.

Figure 3: Number of investment choice by asset size and fund type, 1994-95



Future developments

Reflecting their operational structure and size, retail funds through their product ranges and subfunds are clearly leading the superannuation industry in implementing member investment choice. However, as large superannuation funds continue to consolidate, the resultant larger and more concentrated funds will have a greater diversity of membership and a greater ability to efficiently access more aspects of the investment markets. The market forces arising from this restructuring, combined with the economies of scale available to these larger funds, in time are likely to lead to an increase in the number of members being offered investment options for their superannuation savings.

The declining market share of defined benefit funds

Even though the number of people covered by superannuation has increased significantly during the last decade, the proportion of private sector superannuation members in defined benefit funds has fallen to an all time low of only five percent. In this article we examine the recent trends in the number of defined benefit funds and seek to explain some of the background factors that may be influencing this trend.

A defined benefit superannuation fund is one where at least part of the value of a member's final benefit is determined by their average salary at or near retirement. In this way the investment risk is borne by the fund sponsor. These funds are markedly different to the now much more common accumulation funds where the value of the final benefit is determined solely by the accumulated value of contributions and interest. Defined benefit funds have traditionally been most popular in the public sector, and in long standing private sector corporations with high numbers of white collar staff.

Prior to the major reforms of the superannuation system in the 1980s, less than 40 per cent of workers were covered by superannuation, which was, in practice, largely restricted to public servants and long time employees of major corporations. The advent of award superannuation in the late 1980s and the Superannuation Guarantee (SG) arrangements in the early 1990s opened the superannuation system up to millions of workers who previously were not able to easily participate or benefit from this form of tax preferred savings, often because of restrictive vesting and portability conditions.

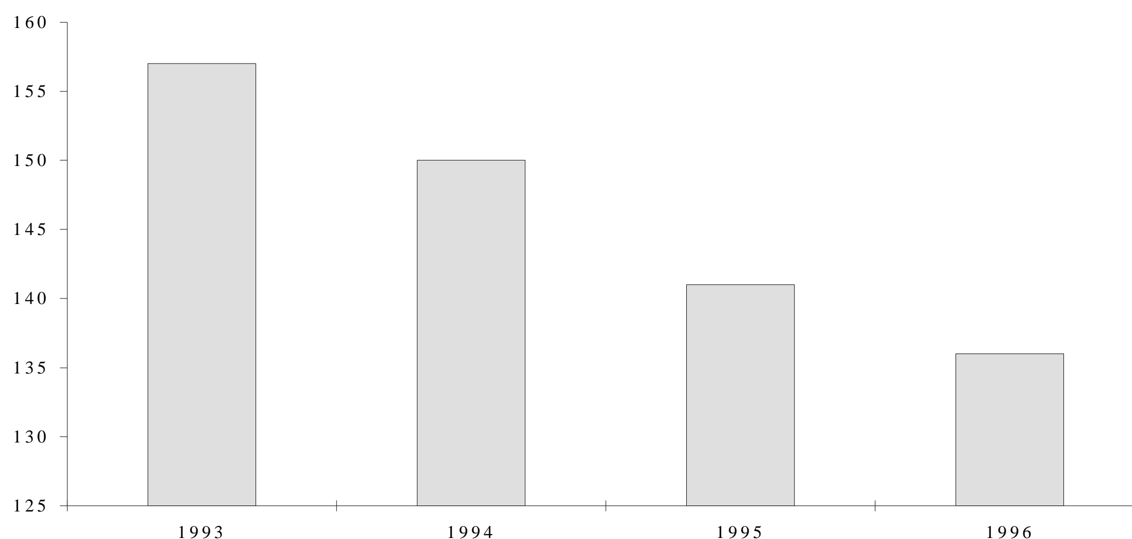
However, the expansion of superannuation coverage into lower income occupational groups was not accompanied by an expansion in the number of defined benefit funds. Instead, it was accompanied by a rapid increase in the number of accumulation type superannuation funds.

Indeed, the number of large companies that sponsor their own defined benefit superannuation fund has been steadily decreasing throughout this period, see figure 1.

Defined benefit funds have traditionally been most suited to companies where the employees have had strong long-term relationships with their employer, for example, public sector employees and longstanding employees of major corporations. These employers were historically quite willing to support company sponsored defined benefit superannuation funds and to guarantee the value of the employees' future retirement benefits as part of their overall staffing policies.

However, under award and SG superannuation, employer contributions from thousands of

Figure 1: Number of private sector defined benefit superannuation funds with 1,000 or more members



different and unrelated employers is typically paid into a small number of specialist industry and public offer ‘productivity’ funds established solely for this purpose. In these funds there is a much weaker long term relationship between the employer sponsors and the employee members. This industrial environment, together with a desire to manage the new award and SG superannuation arrangements as simply as possible, may also have to favoured the creation of accumulation funds rather than more traditional defined benefit funds.

Adding to this, other possible factors that may have encouraged the creation of accumulation funds include a possible desire by employers to shift the investment risk onto their employees, concern by employers to minimise exposure to industrial and regulatory (or compliance related) risk, and the fact that the new award and SG superannuation arrangements were defined in terms of contribution levels (not benefit levels).

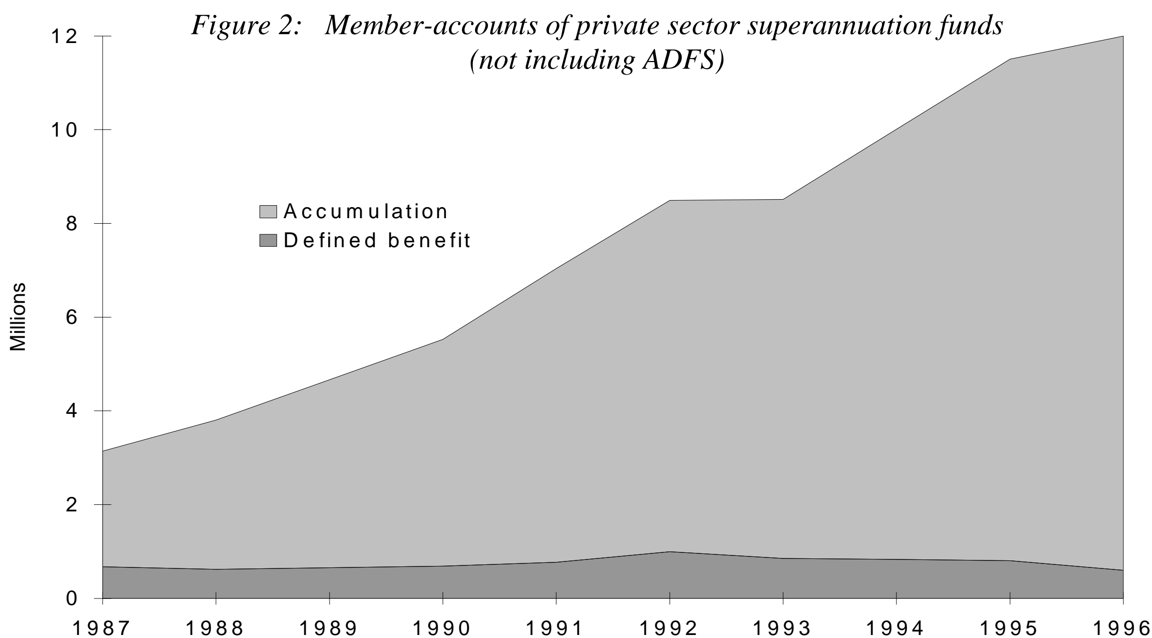
Even though the introduction of award and SG superannuation has lead to a decrease in the popularity of defined benefit funds on the part of private sector employers, they are still overwhelmingly popular among public sector employers. For example, while only five per cent of private sector superannuation member-accounts are in defined benefit funds, 76 per cent of public sector superannuation member-accounts are in defined benefit funds. These defined benefit funds can however have accumulation components.

A more fundamental issue relating to defined benefit funds for their employer sponsors concerns the requirement for the fund’s employer sponsor to make at times very high levels of employer contributions in order to keep the fund solvent and capable of meeting its future liabilities for member retirement benefits. For example, where the benefits are generous and the investment returns poor.

In the case of the public sector defined benefit funds, these high levels of employer contributions do not need to be paid until called upon by the retiring member. Accordingly, a number of public sector defined benefit superannuation funds carry large amounts of unfunded liabilities which will require capital injections from government consolidated revenue in future. Indeed, financial pressures are encouraging many government employers in Australia to restructure their public sector superannuation arrangements to limit these unfunded liabilities and focus much more upon the financial reporting of these public sector defined benefit superannuation funds.

The relatively high levels of employer contributions for private sector defined benefit funds in many cases significantly exceed the mandated SG requirements for employer superannuation contributions. Consequently, an employer that is keen to limit exposure to market risk and potential for unexpectedly high amounts

Figure 2: Member-accounts of private sector superannuation funds (not including ADFS)



of employer contributions in the future, may decide it would be more appropriate to transfer their superannuation arrangements into either a company sponsored accumulation fund, a pooled public offer fund (eg, a mastertrust) or an industry fund. In this situation, if the defined benefit fund is in deficit (ie, its liabilities exceed its assets), the employer sponsor is required to inject sufficient capital into the fund before any transfer can occur.

On the other hand, should a review of the defined benefit superannuation fund reveal the fund to be in surplus, an equally complex industrial issue may arise as to how the surplus should be treated. For example, should it be distributed to the members' accounts, should it be returned to the employer, or should the fund have a 'contributions holiday'? This issue is obviously complex and its management will depend upon the individual circumstances of the fund, subject of course to the requirements for repatriation of surpluses specified in the SIS Act.

Analysis of defined benefit and accumulation fund membership trends and anecdotal evidence, suggests that the complexities and risks associated with defined benefit arrangements have resulted in the vast majority of new superannuation funds being created in the last decade being accumulation and not defined benefit. As a result, nearly all the growth in superannuation membership in the private sector has been in the accumulation sector, see figure 2.

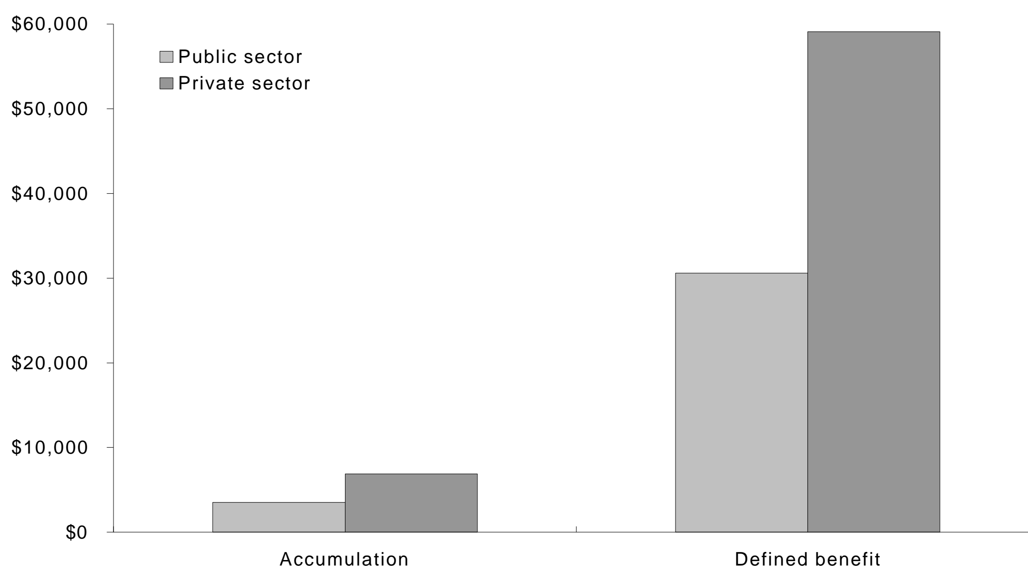
The fact that there have been only slight decreases in the number of member-accounts of defined benefit superannuation funds against this background could among other things reflect the industrial difficulties in transferring members from one type of fund to the other. Not surprisingly, therefore, employers that wish to decrease their exposure to their defined benefit fund tend to do this by closing it to new members and then arranging for any new employees to join the new accumulation fund. In this way the membership of the defined benefit fund will eventually wind down.

Features of defined benefit funds

Members of defined benefit superannuation funds have generally belonged to their fund for longer periods of time than the typical accumulation fund member. In conjunction with the more generous scale of defined benefit employer contributions, this has resulted in the average overall account balance in 1996 for combined public and private sector defined benefit funds at $37 400 being around 5.6 times higher than the average overall account balance for combined public and private sector accumulation funds at $6 700. The fact that members of accumulation funds are more likely to have multiple accounts across several superannuation funds may however, offset this ratio differential to some degree.

Another point worth noting is that the average account balance in 1996 in a *private* sector

Figure 3: Average account balances in 1996



defined benefit fund at $59 100 is nearly twice as high as the average account balance in a *public* sector defined fund at $30 600. This may reflect however, higher relative salaries in the private sector as well as the unfunded nature of many public sector schemes.

An important feature of defined benefit superannuation funds is that, because of their longer term investment focus, they tend to have a more growth orientated asset allocation profile than do many accumulation funds. This is because employer sponsors of defined benefit funds are usually more willing to adopt investment strategies that promote, over the longer term, higher investment returns which can then be used to reduce the costs for the employer. In contrast, because the end-benefit in accumulation funds is critically dependant on investment earnings, trustees and their members have a lower tolerance for volatility in investment returns which can lead to more conservative investment strategies, especially as accumulation funds have no financial sponsor to support the fund should the investment returns be weak.

As a result, defined benefit funds consistently out-perform accumulation funds by an average of one to one and a half percentage points per year. This situation accords with international experience.

It should be emphasised that this performance advantage is not because a fund is defined benefit pe se. Rather it is due more to their longer time horizon. Consequently, this investment performance differential could be overcome if accumulation funds adopted a similarly longer term investment horizon. However, since defined benefit funds operate only in parts of the public and corporate sector, while most accumulation funds operate in the more openly competitive public offer or multi-employer sectors, it is likely that the investment allocation differences between defined benefit and accumulation funds will continue for the foreseeable future.

Countering the more favourable investment performance for defined benefit funds, their average administrative costs per member can be up to 40 per cent higher than is the case for accumulation funds. Since defined benefit funds usually have very high numbers of members and assets under management, these extra costs nonetheless usually translate into lower overall costs when measured in terms of assets under management.

How reliable are the figures in the ISC Bulletin

Many of the figures published in the ISC Bulletin are derived from a combination of statistical estimates from the ISC Quarterly Survey of Superannuation (for large funds)and projected trends from prior year's Annual Returns (for small funds). In this article we compare these estimates with actual figures obtained from the 1994-95 Annual Return to assess the reliability of figures published in the ISC Bulletin.

The ISC Bulletin contains estimates for the structure of the superannuation industry based upon the results obtained from the ISC Quarterly Survey of Superannuation (the Survey) and prior year's Annual Returns. Importantly, these estimates are published within three months of the end of the reporting period, so that June 1996 estimates for the structure of the superannuation industry are available in September 1996.

In contrast, up to date results from the audited Annual Returns do not become available until some 12 to 18 months after the end of the reporting period. However, being audited information, the Annual Return provides a useful benchmark against which to evaluate the validity of the estimates published in the ISC Bulletin. Around 98 000 superannuation funds, ADFs and PSTs have lodged a 1994-95 Annual Return with the Commission.

Reliability of the ISC Bulletin

The close correlation between the previously published estimates and the results obtained from the 1994-95 Annual Return confirm the robustness of the methodology used to produce the superannuation industry estimates published in the ISC Bulletin, see table 1.

The table shows that for assets and members the difference between the published results and the Annual Return results is around one per cent (notwithstanding a number of significant exempt public sector funds that have not lodged an Annual Return with the ISC).

In contrast, the difference between the published and Annual Return results for contributions is around nine per cent. However, the published estimates for contributions in Table 1 are an estimate for the 1994-95 year derived by doubling the published results for the June and September quarters 1995, as there are no Survey contribution results available for the 1994-95 year.

As this derived estimate for 1994-95 contributions is likely to be greater than the level of contributions that would have been obtained had the Survey been in operation during 1994-95, Table 1 shows a greater difference with the Annual Return results than might actually be the case. The nine per cent reporting discrepancy should therefore be seen as an overstatement.

Table 1: Previously published estimates and actual Annual Return results

	Previously published estimates June 1995	Annual Return results 1994-95
Fund Type assets ($billion)		
Corporate	46.2	42.3
Industry	11.3	11.2
Retail	51.6	56.5
Excluded	18.6	18.9
Public sector	57.5	25.5 [1]
Total assets ($billion)	185.2	186.4 [2]
Total contributions ($billion)	25.8	23.7 [2]
Total members (million)	14.9	15.1 [2]

1. Excludes exempt public sector superannuation schemes that have not lodged an Annual return.
2. Includes an estimate for exempt public sector superannuation schemes.

Excluded funds

The estimates for excluded funds published in the ISC Bulletin are based upon the results from prior Annual Returns. Analysis of the excluded fund results from the 1994-95 Annual Returns provides the opportunity to bring the excluded fund estimates up to date. The aggregate figures for excluded funds are derived by multiplying estimated ‘per fund’ ratios by the number of excluded funds, stratified according to whether the fund is new or continuing.

The 1994-95 Annual Return ‘per fund’ asset ratios for excluded funds are slightly higher than those used in the published estimates contained in previous editions of the ISC Bulletin, whilst the ‘per fund’ member ratios are slightly lower. Based upon the 1994-95 Annual Returns excluded funds have on average $195 700 in assets on behalf of 1.95 members, while the previously published estimates assumed $185 900 in assets on behalf of 1.97 members.

The ‘per fund’ contribution ratios for excluded funds from the 1994-95 returns are lower than the estimates currently in use. Employer contributions in particular appear to have reversed the trend from prior Annual Returns and decreased slightly on a ‘per fund’ basis. In contrast, the ‘per fund’ inward transfer ratios for excluded funds from the returns are significantly higher than the estimates currently in use, suggesting that the overall estimates for deposits into excluded funds are very reliable. These results suggest that the structure of excluded funds under SIS is somewhat changed from the structure under the OSSA regime.

Reflecting this change in structure, a new trend for excluded funds has developed whereby some newly established funds are not active in their first year of operation. These funds, considered to be dormant funds, represent up to 10 per cent of all excluded funds.

These latest results have been now incorporated into the excluded fund estimate methodology, so that this edition of the ISC Bulletin includes revised and updated figures for excluded funds.

Highlights from June 1996 Superannuation Survey

Main features

- At the end of June 1996 the value of total assets in the superannuation system was $248.7 billion. This represents an increase of $25.5 billion (11.4%) since June 1995.
- At the end of June 1996 there were 15.9 million member-accounts, up 973 000 (6.5%) since June 1995.
- The number of female accounts is now growing at nearly twice the rate of male accounts. For example, during 1995-96, the number of female superannuation accounts increased by 9% (533 000) compared to an increase of 5% (440 000) in the number of male accounts.
- Around $56 billion (22% of total superannuation assets) was turned over in the superannuation system in gross contributions and gross benefit payments during 1995-96 (including around $14 billion in transfers).
- Largely reflecting high labour market turnover and growth in part-time employment, during 1995-96, around 3.5 million accounts were created and 2.6 million accounts were wound-up. A total of 6.1 million accounts were therefore turned-over during the year (39% of total member-accounts).
- The $7.6 billion growth in superannuation fund assets during the June quarter was due primarily to $4.6 billion (60%) in net deposits. Net earnings accounted for the remaining $3.0 billion (40%). This break-up reverses the situation of a year ago, when net earnings accounted for 61% ($5.8 billion) of the increase in superannuation fund assets and net deposits accounted for 39% ($3.7 billion).

Industry structure

Public sector funds now hold 26% ($64.5 billion) of total superannuation assets, retail funds hold 24% ($59.5 billion), corporate funds 20% ($49.9 billion), excluded funds 10% ($24.2 billion), and industry funds 6% ($14.6 billion). The remaining 14% ($36 billion) of superannuation assets represent the annuity products, fund reserves and unallocated profits of life office statutory funds.

Industry funds experienced the greatest growth in total assets during 1995-96 with their assets increasing by 29% ($3.3 billion). This increase was closely followed by the 28% ($5.3 billion) growth in excluded fund assets. In contrast, retail fund assets increased by 16% ($8.3 billion), public sector fund assets increased by 12% ($7 billion) and corporate fund assets increased by 8% ($3.7 billion) during 1995-96.

The only component to decrease in asset size during the year to June 1996 was the combined category of annuity products, fund reserves and unallocated profits held in life office statutory funds, which decreased by 5% ($2 billion). This result implies a significant net outflow of funds from this component, most likely into excluded funds and other ‘non-life’ retail superannuation funds.

Contributions and benefits

Employers continue to contribute the majority of all contributions. For example, during 1995-96, employers contributed $17.5 billion (68%) into superannuation while employees contributed $8.2 billion (32%).

Transfers into superannuation funds accounted for 35% ($13.9 billion) of all fund deposits during 1995-96.

Lump sums accounted for 79% ($12.7 billion) of the benefits paid during 1995-96, excluding transfers. The remaining 21% ($3.4 billion) of benefits were paid as pensions. These proportions are however reversed when the capitalised value underlying the pension payments is considered, as the $3.4 billion in pension payments represents a capital value of around $45 billion (77%), compared to the $12.7 billion (23%) paid in lump sums.

Transfers out of superannuation funds accounted for 42% ($11.6 billion) of all fund withdrawals during 1995-96.

A seasonal pattern is particularly noticeable for contribution levels and to a lesser extent benefit levels. Contribution levels are greatest during the June quarter and lowest during the September quarter. This most likely reflects organisations finalising their superannuation obligations and taxation positions prior to compilation of annual reports. In fact, the June 1996 quarter contributions were 34% higher than for the September 1995 quarter contributions.

Conversely, the greatest benefit payment levels occurred in the September quarter. Net contributions (that is, contributions less benefit payments) in the June quarter were 2.25 times those in the preceding September quarter, thus showing distinct seasonal variation.

Manner of investment

At the end of June 1996 the statutory funds of life offices retained the largest share of the total assets of superannuation, holding 38% ($93.3 billion) of assets. However, this share is continuing to decline at a rate of around 1% per year. For example, in June 1992, life offices held 44% of superannuation assets.

Investment managers held 33% ($82.1 billion) of superannuation assets at June 1996, the same proportion as in June 1995. The remaining 29% ($73.3 billion) of superannuation assets were directly invested.

During 1995-96, directly invested superannuation assets experienced the largest growth (16%), followed by assets held with investment managers (11%), and assets held in the statutory funds of life offices (8%).

Asset allocation

Superannuation assets invested overseas increased marginally from 15.5% at the end of March 1996 to 15.6% at the end of June. With the TWI increasing by 2.3% during the June quarter (acting to automatically decrease the AUD value of overseas investments), this result implies that trustees invested an additional net $1.8 billion overseas during the quarter. This may reflect trustees continuing to take advantage of a rising AUD in overseas markets.

Superannuation investment in equities decreased slightly (by 1.2%) during the June quarter. Since the ASX accumulation index rose by 1% during the quarter it follows that there was a net flow of around $1.4 billion out of the equities markets by superannuation funds. This decrease in superannuation equity holdings had the affect of decreasing the overall proportion of superannuation assets invested in equities to 28%.

Holdings of long term debt securities increased slightly by 1.3% ($0.6 billion) during the June quarter, while long term bond yields were steady at 8.9% during the quarter. The proportion of superannuation assets held as long term debt securities remains at 19%.

Holdings in short term debt securities rose by 1.8% ($0.3 billion) during the June quarter, while short term yields also rose from 7.55% to 7.60%. The proportion of superannuation assets held as short term debt securities remains at 8%.

These movements would appear to indicate that during the June quarter superannuation funds were net sellers of Australian equities. In contrast, they were net purchasers of overseas assets and short term debt securities.

The proportion of superannuation assets invested in cash, deposits and placements remained steady (at 10%), while assets held as direct property (at 7%) and unit trust holdings (at 9%) were steady. Other investments account for around 4% of total superannuation savings.