APRA

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Prudential regulation under Wallis

The Treasurer, the Hon Peter Costello MP, released the final report of the Financial System Inquiry (the Wallis Report) on 9 April 1997. The Report contains 115 recommendations for regulatory reform in the financial sector, but - except in the area of competition policy - the Government has not yet responded to its many proposals.

Put simply, the Wallis Report sees the regulatory framework for the financial sector as consisting of three separate pillars: **central banking** (monetary policy, payments system, systemic stability); **prudential regulation** (safety of deposit taking, insurance and superannuation); and **conduct** and **disclosure** regulation (companies, markets, consumer protection). This article is only concerned with the second pillar, ie prudential regulation.

The ISC regulates insurance companies and brokers for conduct and disclosure purposes. Apart from this, however, the core business of the ISC is prudential regulation, ie licensing insurance companies and superannuation schemes and monitoring their long-term financial soundness with a view to protecting -but not guaranteeing - the financial interests of insurance policyholders and superannuation members.

Therefore, of most relevance to the ISC are the Report's recommendations in relation to financial safety (recommendations 30 through 55).

The statutory basis and broad techniques for prudential regulation of insurance and superannuation are found in the Insurance Act (for general insurance), the Life Insurance Act (for life insurance) and the Superannuation Industry (Supervision) or SIS Act (for superannuation). The Wallis Report was essentially conservative in regard to the techniques of prudential regulation; in effect, it endorsed the current thrust of these three Acts, and the corresponding prudential regimes for deposit-takers (ie, banks, building societies and credit unions).

However, the Report did recommend a major restructuring of the regulators. Under Wallis, mudential reaulation would be transferred to a new agency - the Australian Prudential Regulation Commission (APRC) - from the present prudential regulators, ie: the Reserve Bank (for banks), the ISC (for insurance and superannuation), and the Australian Financial Institutions Commission and related State authorities (for building societies and credit unions).

Consolidating prudential regulation in one agency would generate a number of substantial benefits. In particular, the new agency (the APRC) would have a sharper focus and clearer sense of purpose than presently obtains under the existing, somewhat fragmented arrangements; and the prudential regulation of financial conglomerates engaged in banking, insurance and superannuation would be greatly facilitated and better coordinated. We have not seen any arguments *of substance and relevance* against the concept of a single prudential regulator. A similar arrangement works well in Canada.

The regulatory framework proposed by the Wallis Report would require the central bank (Reserve Bank) and the prudential regulator (APRC) to work closely together, because of the overlap between their respective responsibilities for systemic stability and prudential regulation. The Report also recommended that the APRC be headquartered in a major financial capital rather than Canberra.

It is not yet clear what decisions the Government will make in response to the Wallis recommendations. It is expected that the Treasurer will outline the Government's response in a statement later this year. In the meantime, the ISC will continue to administer the Insurance Act, Life Insurance Act and SIS Act in the interests of safety, stability and efficiency in the insurance and superannuation sector.

Retirement Savings Accounts

Banks, building societies, credit unions and life insurance companies can now offer superannuation directly in the form of Retirement Savings Accounts (RSAs). In this article we look at the key characteristics of RSAs and how they are regulated.

Legislation has recently been enacted to permit banks, building societies, credit unions and life insurance companies to offer superannuation without a trust structure in the form of Retirement Savings Accounts (RSAs) from 1 July 1997, as foreshadowed in the 1996-97 Budget.

Over time, the introduction of RSAs - combined with increasing member choice of fund - is expected to inject substantial levels of competition into the superannuation industry. This, in turn, should place downward pressure on fees and charges, encourage better standards of service and expand the range of products available to consumers, particularly those with lower risk preferences.

Characteristics of RSAs

In essence, RSAs are deposits or life policies with a tax-advantaged, superannuation character. They are expected to be simple, low cost, low risk products that are easily accessible through the existing distribution systems of RSA providers.

Superannuation has traditionally been provided through a trust structure. However, the trust structure, with its separation of legal and beneficial ownership and the fiduciary obligations of trustees, is less relevant in the case of *prudentially supervised* institutions such as banks, building societies, credit unions and life insurance companies.

RSAs will therefore be able to be provided by these institutions directly from their balance sheet or statutory fund. This will facilitate more cost-efficient delivery of superannuation, without compromising the security of superannuation benefits.

The Government's statement on RSAs in the 1996-97 Budget indicated that RSAs will be especially suited to people with small amounts of superannuation, such as casual and itinerant workers.

RSAs will also be suited to workers who want to amalgamate several small superannuation holdings, and those people between jobs or nearing retirement who wish to minimise the market risk on their superannuation savings.

They will also provide a flexible and convenient superannuation vehicle for persons with broken working patterns, particularly women, and for small business employers seeking to discharge their Superannuation Guarantee obligations.

For self-employed workers and for employees making 'top up' contributions, who already have member choice of fund, RSAs provide another option in the available range of retail superannuation products.

Three key characteristics of RSAs are their personal or individualised 'account based' nature; the 'capital guarantee' underlying the product; and the portability rules.

First, the absence of trustee intermediation will reduce the superannuation arrangement to one of debtor/creditor in the case of banks, building societies and credit unions, or a contractual relationship in the case of life offices. In this sense, it can be said that an RSA is 'owned and controlled' by the RSA holder (the person in whose name the account is held or who is the owner of the policy). The RSA holder will be able to make contributions to the RSA or have their employer make contributions on their behalf.

Second, RSAs are required to be 'capital guaranteed', reflecting the lower risk nature of the product. The effect of the capital guarantee means that where the RSA is an account offered by a deposit-taking institution, the account balance cannot be reduced by the institution crediting negative interest. Where the RSA is a life policy issued by a life insurance company, the contributions cannot be reduced by negative investment returns or by a reduction in the value of the assets in which the policy is invested.

In addition, RSA balances under $1,000 are 'member protected', consistent with the mandatory protection of small trust based superannuation balances (which cannot go backwards as a result of fees and charges). In essence,

Table 1: Characteristics of RSA

1. Offered by banks, building societies, credit unions and life insurance companies
2. No trust structure
3. Lower risk/lower return
4. Capital guaranteed
5. Fully portable
6. Owned and controlled by employee
7. Simplified disclosure

therefore, benefits in an RSA can only be reduced by the imposition of fees and charges by the RSA provider where the balance is over $1,000 (RSA fees and charges are expected to be low, and must be fully disclosed to the RSA holder on entry and in annual statements).

Third, RSAs are fully portable. That is, subject to any notice period in the terms and conditions of the contract or agreement (but in any event, within 12 months), the RSA provider must transfer the balance of an RSA to another superannuation vehicle at the RSA holder's request. In addition, where an RSA is opened by an employer on behalf of an employee, the employee will have a 14 day 'cooling off' period during which time the account balance can be transferred to another RSA or superannuation entity free of charge. The portability rules ensure that the RSA holder retains flexibility and choice in the management of their superannuation savings.

Regulation of RSAs

Regulation of RSAs will consist of prudential supervision for institutional soundness of the RSA provider and functional supervision for compliance with retirement income and other superannuation standards.

Prudential supervision will be carried out under the existing regulatory frameworks. That is, by the Reserve Bank of Australia in the case of banks, the Australian Financial Institutions Commission and State Supervisory Authorities in the case of building societies and credit unions, and the ISC in respect of life insurance companies.

Functional supervision of RSAs and RSA providers will be undertaken by the ISC. The essential purpose of the ISC's functional supervision role is to ensure that RSAs are properly integrated into the superannuation framework.

The ISC will administer an approval and annual reporting process, and will put in place procedures for ensuring ongoing compliance. The ISC will investigate alleged breaches of the superannuation standards by RSA providers, in consultation with the prudential regulator, in order to ensure appropriate remedial action is undertaken.

The RSA legislation confers extensive investigation and enforcement powers on the ISC, including the capacity to suspend or revoke an RSA institution's approval for flagrant and persistent breaches of the standards.

To avoid overlap and duplication with the prudential regulator, the ISC will be adopting a relatively non-intrusive, 'self-assessment' approach to the approval of RSA institutions. For example, rather than conducting intensive, on-site examinations of applicants' capacity to comply with the retirement income and superannuation standards, the ISC will generally rely on certification at the highest levels of an institution as to its compliance capabilities and procedures, as well as close consultation with the relevant prudential supervisor, in assessing applications for approval.

The superannuation standards set out in the RSA legislation are closely modelled on the regulatory regime currently in place for superannuation entities under the *Superannuation Industry (Supervision) Act 1993* (SIS Act) and the SIS Regulations. That is, in keeping with their tax-advantaged status, RSAs will be subject to the retirement income standards applying to other superannuation products including preservation, contributions eligibility and disclosure. However, there are two significant points of departure relating to disclosure rules and employee choice.

First, the point of sale disclosure rules have been simplified in recognition of the capital guaranteed nature of RSAs. This has primarily been achieved by omitting the overriding 'everything the investor reasonably needs to know' type of disclosure requirement that applies to collective investments generally, in favour of detailed specification of the items that must be included in RSA disclosure statements (although not the form in which they must be presented). The RSA provider will also be required to inform the RSA holder of the 'lower risk/lower return' nature of RSAs, and of the need to assess alternative higher yielding investment opportunities when an RSA balance reaches $10,000.

Second, the RSA legislation has broadly anticipated the Government's 1997-98 Budget announcement relating to increased member choice of fund in superannuation. Following amendments to the RSA legislation in the Senate, employees must be given a choice of alternative superannuation vehicles before they are signed up to RSAs by employers. In particular, the alternatives to the employer-preferred RSA must at least include an RSA with an institution that is accepting the employee's salary (if relevant); a relevant industry-based superannuation fund; and another regulated superannuation fund.

This means in practice that in respect of new employees, an employer is able to open an RSA for the employee where the employee positively opts for the RSA within 28 days or fails to make any choice within that period. For existing employees (in respect of whom the employer is already making contributions to a superannuation fund), the employer is only able to open an RSA where the employee positively opts for the RSA within 28 days. If the employee is silent, the employer must as the default option continue to contribute to the employee's existing superannuation fund.

It is expected that these arrangements will be superseded by the more extensive 'member choice' arrangements announced by the Treasurer in the 1997-98 Budget, which will take effect for new employees from 1 July 1998, and for existing employees from 1 July 2000.

An annual supervisory levy will be imposed on RSA providers that offer, or have offered, RSAs and who lodge an annual return with the ISC. The levy, to be determined in consultation with stakeholders in early 1998, will be designed to effect full cost recovery of the ISC's supervision of RSAs.

Consumer complaints about RSAs, which cannot be resolved by an RSA provider's internal complaints handling mechanism, will be dealt with by the Superannuation Complaints Tribunal.

Table 2: -Characteristics of RSA look-alikes

1.	May be provided by dedicated public offer superannuation funds or by a dedicated sub-fund of a public offer superannuation fund
2.	Trust structure
3.	Investment rules ensuring equivalent capital guarantee to RSAs proper
4.	May use similar reduced disclosure to RSAs proper
5.	May use term 'RSA' for marketing purposes

'RSA Look-alikes'

In order to maintain a level playing field between RSA providers and traditional retail superannuation funds, the SIS Regulations have been amended to facilitate the provision of 'RSA look-alikes' by public offer superannuation funds (which are trust based entities regulated under the SIS regime).

Public offer superannuation funds which offer products with an equivalent and suitably backed 'capital guarantee' to RSAs proper, will be able to use the same reduced disclosure requirements as RSAs and use the term 'RSA'. To achieve an equivalent 'capital guarantee' to RSAs, the assets underlying the separate fund or sub-fund through which the 'RSA look-alike' is provided must be invested wholly in prudentially supervised institutions such as banks, building societies, credit unions or life offices.

Public offer superannuation funds offering products with this form of 'capital guarantee' will also be required to make the same disclosure to members about the lower risk/lower return nature of the product, including where the balance reaches $10,000, even where the product is not 'badged' as an 'RSA'.

Copies of the RSA Act, RSA Regulations and amendments to the SIS Regulations are available from Commonwealth Government bookshops and are set out in the ISC Superannuation Digest.

The RSA Act will also soon be available on the ISC internet home page http://www.isc.gov.au.

More on superannuation contributions

Reflecting increased confidence in superannuation, contributions over the financial year 1996 -97 to date are up 14 per cent compared to 1995-96, and are projected to amount to $29 billion by year's end. In this article we briefly assess the long term trend in contributions and examine the sectors showing the strongest growth.

Aggregate contributions over the first three quarters of 1996-97 were around 14 per cent higher than for the corresponding quarters in 1995-96. If current growth rates continue, contributions for the year should exceed $29 billion. See figure 1.

Preliminary ISC analysis predicts the level of SG (ie, compulsory) contributions will be around $14.2 billion for 1996-97. It seems therefore that Australia's workers are achieving aggregate contributions into superannuation at around twice the minimum amount required.

Reasons for the growth in contribution levels may include the increase in the minimum SG contribution amount paid by employers with payrolls less than $1 million (increasing for 1996-97 from five to six per cent), and renewed attention being paid by Australian workers to their retirement savings - particularly in a period of healthy earnings.

It is likely the small business SG increase counted for slightly more than one third of the 14 per cent increase in overall contributions. This is because, according to Australian Bureau of Statistics figures, these employees and their employers represent around 32 per cent of superannuation members.

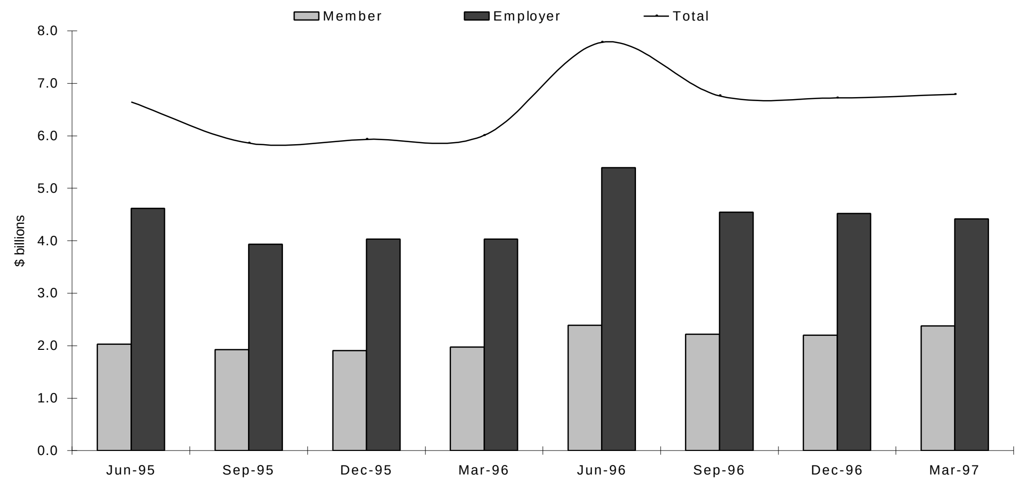
There also appears to be strong seasonality patterns in superannuation contributions, particularly employer contributions. For example, aggregate employer contributions in the June 1996 quarter were more than one third greater than the average aggregate employer contributions made in the preceding three quarters, clearly showing the strong link that exists for employers between superannuation contributions and their taxation arrangements - particularly their SG obligations.

Net contributions, that is contributions less benefit payments, are growing even more rapidly than overall contributions. For example, over the first three quarters of 1996-97 aggregate net contributions were nearly 25 per cent higher than for the corresponding 1995-96 quarters. Net new money flowing into superannuation in 1996-97 should therefore reach around $12 billion. This result reflects the relatively weaker growth in aggregate benefit payments (up less than nine per cent over the first three quarters of 1996-97).

Aggregate employee contributions - usually in the form of 'top up' contributions - for 1996-97 are also growing strongly and are estimated to be around $9.6 billion (up 17 per cent on 1995-96 based upon the first three quarters). While most likely influenced by the savings behaviour of high income individuals, this indicates that superannuation continues to be seen as a very attractive long term savings vehicle.

Aggregate employer contributions are estimated to be around $19.5 billion for 1996-97 (up 12 percent on 1995-96). While not growing as strongly as employee contributions, employers are still contributing significantly more than the minimum SG requirement.

Figure 1: Contributions into superannuation



Contributions and fund type

Retail superannuation contributions have shown the greatest growth during the 1996-97 year, increasing by 29 per cent during the first three quarters compared to the corresponding quarters in 1995-96. This has enabled retail funds to increase their aggregate share of contributions from 27 per cent in 1995-96 to 30 per cent in 1996-97. See table 1.

This possibly reflects the strong growth of mastertrusts which may be being fuelled by the consolidation in the small corporate fund sector.

Within the retail sector, retail funds controlled by banking groups have shown the greatest increase in contribution levels, up 68 per cent during the first three quarters of 1996-97 to nearly $500 million. This may possibly reflect increasing orientation of the banking sector toward the superannuation industry through competitive use of their distribution networks.

Despite this growth in banking sector retail contributions, the banking sector is still a minor player within the market for superannuation contributions, however the introduction of RSAs from 1 July 1997 is expected to change this. It should be appreciated however, that the banking sector is a very major player in the investment management market, managing in excess of 40 per cent of superannuation assets.

Reflecting public sector downsizing, public sector funds are showing the slowest rate of increase in contributions, up only four per cent in 1996-97. Consistent with the consolidation in the corporate fund sector already mentioned, corporate fund contributions in 1996-97 are up only five per cent.

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Table 1: Contributions and fund type

	1956-96			1996-97 (estimated)	
Fund type	Contributions ($b)	Industry share	Growth	Contributions ($b)	Industry share
Public sector	8.9	35%	4%	9.3	32%
Retail	6.9	27%	29%	8.9	30%
Corporate	3.6	14%	5%	3.8	13%
Industry	3.1	12%	17%	3.6	13%
Excluded	3.0	12%	16%	3.6	12%
All funds	25.6	100%	14%	29.1	100%

Growth.for 1996-97refers to growth observed for the September, December and March quarters of 1996-97 as compared to the same quarters in 1995-96.

A progress report on member investment choice

In the June 1996 ISC Bulletin we examined the extent to which investment choice has been implemented choice across the superannuation industry. In this article we update this analysis to incorporate information from the 1995-96 Annual Returns.

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, superannuation funds can now establish investment strategy choices for members who would like a greater say in how their superannuation savings are managed. Under the superannuation legislation, funds are permitted - but not required - to offer a mix of appropriately designed investment strategies to their members.

Superannuation fund members have investment choice when the fund trustees offer them a choice of investment , that is, a choice from a range of options generally offering different investment mixes, styles, risks or expected returns. Members that do not actively make a choice are assigned a default strategy.

Member investment choice allows members to select one or a combination of predefined strategies to more closely match their particular superannuation goals and needs. For example, choosing a growth strategy, balanced strategy or a capital guaranteed strategy, members have more control in the accumulation of their retirement savings according to their own particular risk/return preferences.

Characteristics of funds that offer choice

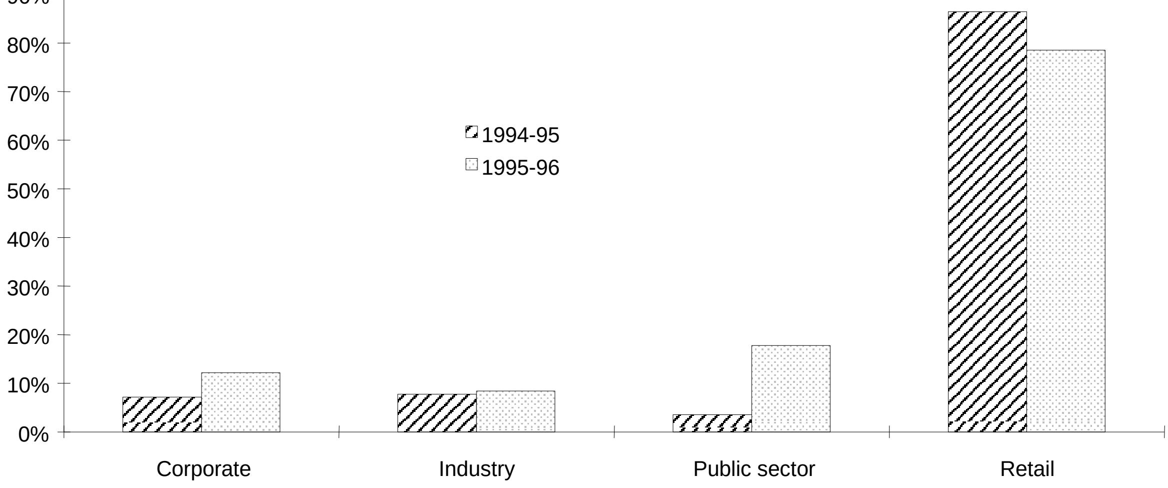
During 1995-96, the proportion of non-excluded funds that offered investment choice increased marginally from 12.6 to 12.7 per cent. However, the proportion of members in the total superannuation system covered by investment choice decreased marginally from 43.3 to 42.7 per cent. As would be expected, retail funds continue to be more likely to offer investment choice than other funds. More notably, 47 per cent of all contributions are now paid into funds with investment choice (up from 30 per cent in 1994-95)

In 1995-96 member investment choice was offered by 53 per cent of retail funds, up from 46 per cent in 1994-95. By comparison, only 9.3 per cent of non-retail funds offered choice in 1995-6, down from 10 per cent in 1994-5.

In addition, the proportion of all fund members that had member investment choice fell marginally in 1995-96. Despite this, non-retail super funds actually reported an increase in member investment choice. See figure 1.

The high proportion of member investment choice in retail funds, compared with other funds, reflects the significant differences in the operation of different fund types. For example, many retail funds are complex groupings of superannuation products (where the 'fund' is the legal umbrella entity). Also, by their very nature, retail funds tend to be more customer aligned in attempting to meet the needs of their potentially broad and diverse membership base. It is not surprising therefore that a relatively high level of these funds offer investment choice.

Figure 1: Members in funds with investment choice



On the other hand, the comparatively low incidence in 1994-95 and 1995-96 of investment choice for corporate, public sector and industry funds may simply reflect the more direct and automatic fund-to-member nature of these funds, which capture superannuation savings directly from their members rather than from product pools.

Consistent with this, the small average member account balances of industry funds (only around $2,900 per member account in 1995-6) suggests that there is little active demand at present by industry fund members for investment choice. Despite the increase in the number of industry funds that have commenced to offer member choice of investment over the past year, the increased coverage of investment choice has tended to occur in smaller industry funds with low average member balances.

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, may also be a disincentive for offering investment choice.

Moreover, the majority of defined benefit plans, for which member investment choice is not always relevant, are found in these sectors. In 1995-96 only 4.6 per cent of all defined benefit funds offered member investment choice (typically in relation to the member contribution component), compared with 17 per cent of accumulation funds.

The prevalence of member investment choice in retail funds is also linked to retail funds having the largest membership, as the likelihood of a fund providing investment choice increases strongly with the size of the fund. See figure 2.

This suggests, as would be expected, that more diverse and sophisticated investment options become viable and 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 therefore clear that member investment choice is significantly affected by economies of scale. For example, over 93 per cent of members from funds with more than 10,000 members have access to member investment choice, whilst almost seven per cent of members of funds with fewer than 10,000 members have investment choice.

Similarly, only four per cent of members in funds with assets of less than $10 million had investment choice, and to discourage members from excessive conservatism, risk-taking or short-termism. Large funds may also be better placed to offer effective member education programs that are necessary to support member investment choice.

Since economies of scale appear to be a strong factor in the implementation of investment choice, it follows that investment choice is likely to be relatively more expensive for small funds than large funds. In fact, funds with less than 10 members that offer investment choice have average administration expenses of $52 per week per member, whereas funds with more than 10,000 members that offer investment choice have administration expenses of $1.66 per week per member.

Figure 2: Proportion of funds with investment choice

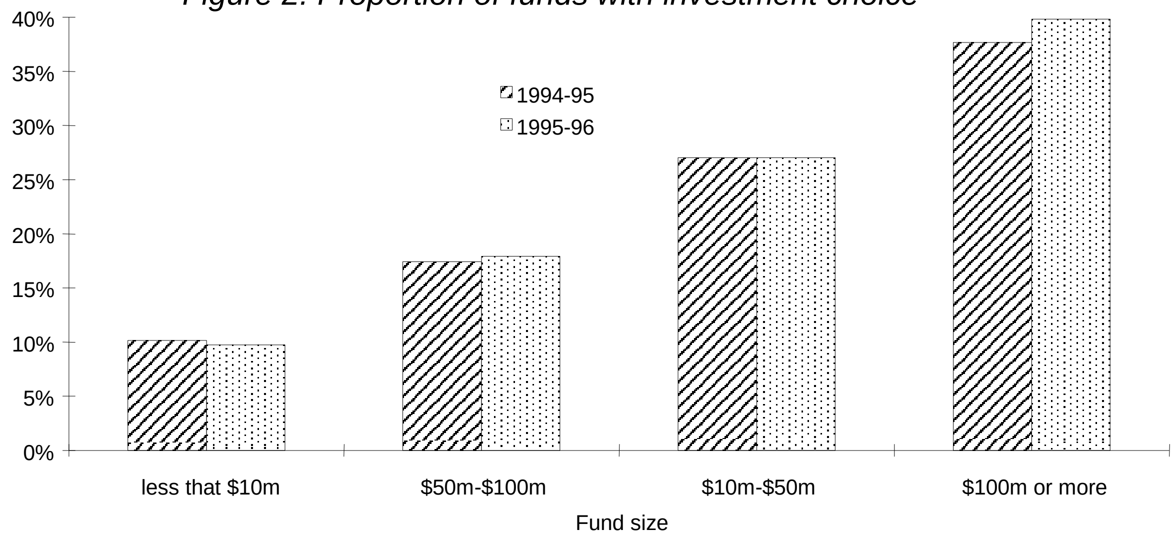
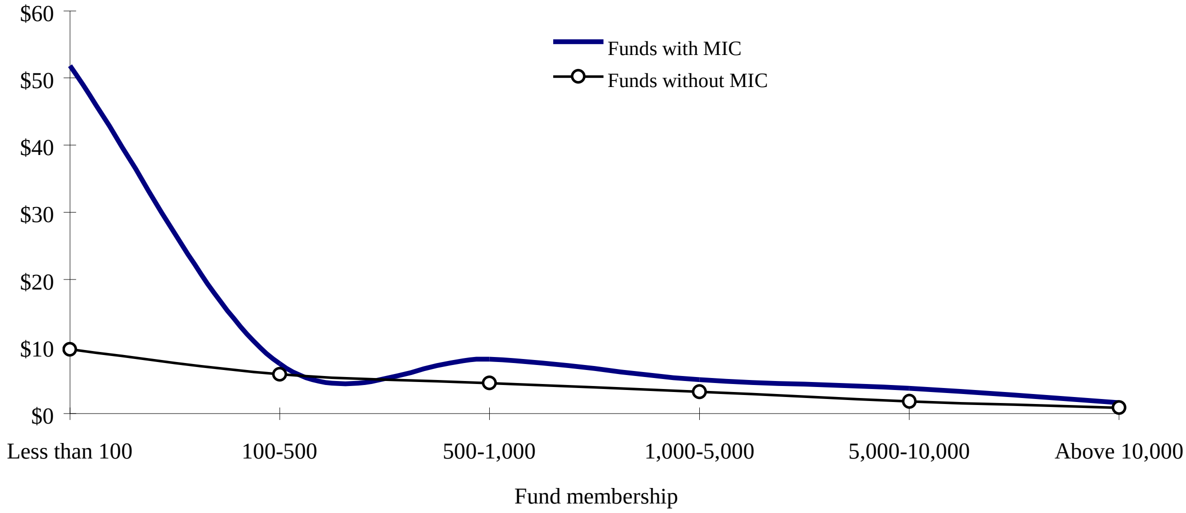


Figure 3: Weekly administration costs per member



By way of comparison, funds without member investment choice for those respective membership ranges had administration expenses of $10 per week and $0.91 per week.

Most importantly though, the gap between weekly administration expenses for funds with member choice and without member choice closes as fund membership increases. See figure 3.

Number of investment choices

While the types of investment choices may include low and high risk options with associated volatilities and likely expected returns, the average number of investment choices offered may vary considerably by fund type. Variations due to asset size are however much less significant.

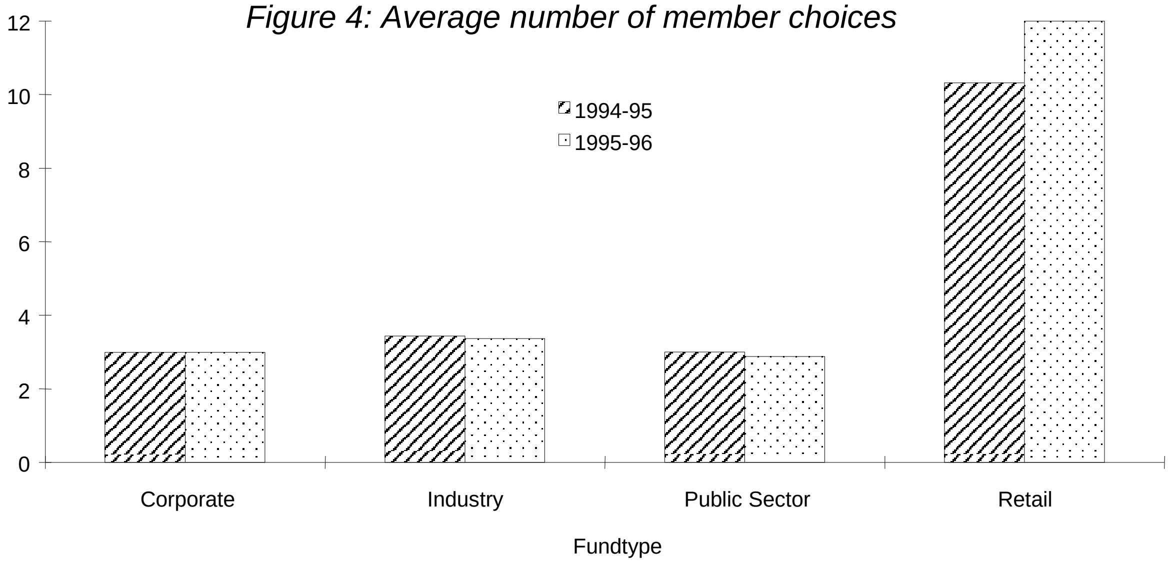
The average number of choices available from all funds offering investment choice also increased very slightly during 1995-96 from 5.8 to 6.0.

Retail funds offering investment choice average 12 investment choices while non-retail funds offering investment choice average three investment choices, most commonly a growth option, a capital stable option and a balanced option. See figure 4.

Likely future developments

While retail funds, through their product ranges and subfunds, lead the superannuation industry in implementing member investment choice, the tendency for large superannuation funds to consolidate means that the resultant larger and more concentrated funds will also have a greater diversity of membership and a greater ability to efficiently offer member investment choice. And the introduction of fund choice is likely to promote this development even further.

Figure 4: Average number of member choices



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.

Superannuation fund administration - latest analysis

Operating a large superannuation fund requires the efficient administration of Many functions such as processing of member entries and exits, contributions, benefit payment, financial reporting and accounting. In this article, we profile the administration market for large superannuation funds.

To ensure that a fund's administrative functions are properly carried out, trustees have the choice of having the administration run by the fund itself (internal administration) or contracting the fund administration to a specialist superannuation organisation (external administration). When considering which option to pursue, trustees also need to assess associated issues such as cost, fund expertise and access to systems infrastructure.

In this article we profile the Pond administration market for non-excluded funds and identify the major differences between funds using internal and external administration. We also investigate whether any cost differences are involved in the different strategies. Finally we review the trustee management structures within today's superannuation market.

External administrators

Nearly 56 per cent of all large funds use an external administrator. Industry funds are the highest users of external administrators (at 74 per cent of funds) while retail funds, most likely due to their greater ability to draw upon their inhouse administration operations, are the lowest users of external administrators (at 41 per cent of funds). See figure 1.

During 1995-96 the *proportion* of corporate funds using external administrators increased by around 11 percentage points (up from 46 per cent to 57 per cent). However, the *number* of corporate funds using an external administrator increased by only around seven per cent during this time. As the number of corporate funds consolidated by around 12 per cent during 199596, this result suggests that it was predominantly the internally administered corporate funds that were restructuring, most probably by rolling into either master trusts or industry funds.

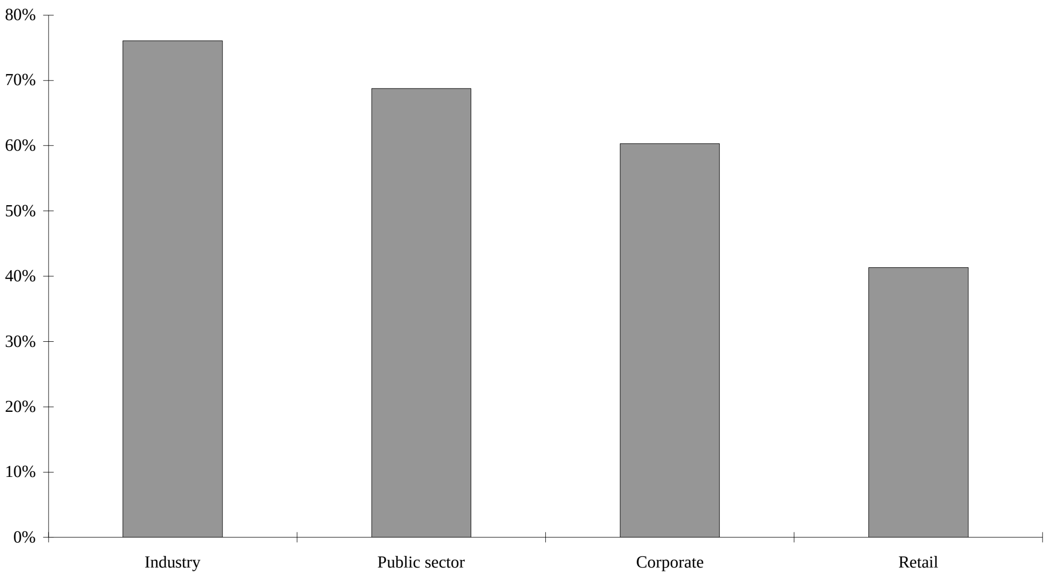
Variation between the use of internal and external administration is however even more marked when viewed from a benefit structure basis. For example the more difficult and specialised administration requirements needed for defined benefit funds result in around 86 per cent of these funds using an external administrator, while only around 50 per cent of accumulation funds use an external administrator.

An overriding issue regarding whether to use an external administrator however, is the extent of economies of scale and the level of in-house expertise. For example, the funds most likely to use an external administrator are those with between 100 and 5 00 members (see figure 2).

This suggests that funds in this membership range are least likely to have access to the expertise and economies of scale required to have efficient internal administration. However, as the size of the fund membership increases, the use of external administration decreases, suggesting that economies of scale associated with increasing membership make the use of internal administration a more viable option.

A notable exception to the general rule of external administration being more common for smaller funds is that trustees of funds with fewer than 100 members

Figure 1: Use of external administration and fund type 1995-96



are least likely to make use of external administration. This may however reflect a desire by these small business trustees to have more direct or 'hands on' control over the operations of their fund.

However, within this smaller membership range, the cost of external administration can become prohibitive and this may also be a factor in the decision to choose internal administration. For example, for these funds, operating expenses, including both administration and investment management expenses, are around two and a half times greater on a per member basis for funds using external administration than for funds using internal administration. See figure 3.

One reason for the differential operating costs for these small membership funds may be the impact of internal subsidies for the administration of the superannuation fund. This occurs when an employee's cost of working on superannuation fund matters are absorbed by the employer without an explicit charge being made to the fund for the employee's time and resources. In fact, previous ISC analysis has indicated that up to 25 per cent of corporate funds fully subsidise the cost of their fund's administration.

As mentioned previously, it appears that it is funds using internal administration that are predominantly consolidating. This may be because, for cost effectiveness reasons, it is not viable to use an external administrator, a factor which foreshadows a subsequent commercial decision for the fund to cease existing in its current form.

Moreover, previous ISC research indicates that in two thirds of cases where a fund is restructured, it is actually transformed into a small self-managed fund for the owner of the business, with the other fund members and their equity being rolled into an industry fund. In the remaining one third of cases when the fund is wound up, all the members -including the employers - and their equity are most likely transferred into a mastertrust.

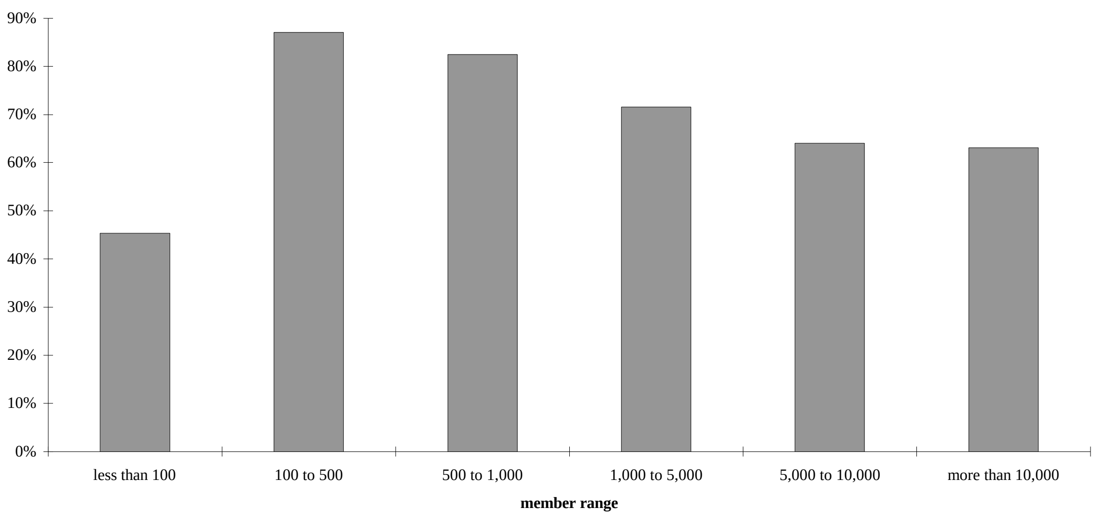
For funds with more than 500 members there is little difference in unit operating costs between funds with internal administration as opposed to external administration, suggesting that cost may not be the critical factor in the decision to use external administration in these cases. A more important factor may be access to expertise and system requirements.

A strong implication to be drawn from figure 3 is that after the 1,000 member level is reached there are significant economies of scale to be achieved in fund operating expenses. For example, funds with more than 10,000 members on average have per member operating expenses around two thirds less than funds with 1,000 members, regardless of the type of administration.

Market concentration

As at June 1996 there were around 2,700 funds using external administration, holding $88 billion in assets on behalf of around

Figure 2: Use of external administration and fund size 1995-96



9.6 million member accounts (not including exempt public sector superannuation schemes).

The external administration market was worth around $800 million in 1995~96 (in terms of administration expenses incurred by superannuation funds), with some 250 specialist superannuation organisations providing the administration services to these funds. However, the superannuation administration market, like many finance sector markets, is relatively concentrated. See Table 1.

Table 1: Administrator concentration

	Funds	Members	Assets
Top 5	44%	8%	24%
Top 10	59%	24%	37%

This level of concentration is similar to the level of concentration within the investment management market. For example, whereas the top 10 administrators manage 59 per cent of funds, the top 10 investment managers control 56 per cent of the investment management market.

Although the administration market is relatively concentrated in terms of funds, it is important to note that these funds represent a much smaller proportion of all member accounts and assets.

For example, the 44 per cent of funds controlled by the top five administrators represent only eight per cent of externally administered member accounts and 24 per cent of externally administered assets.

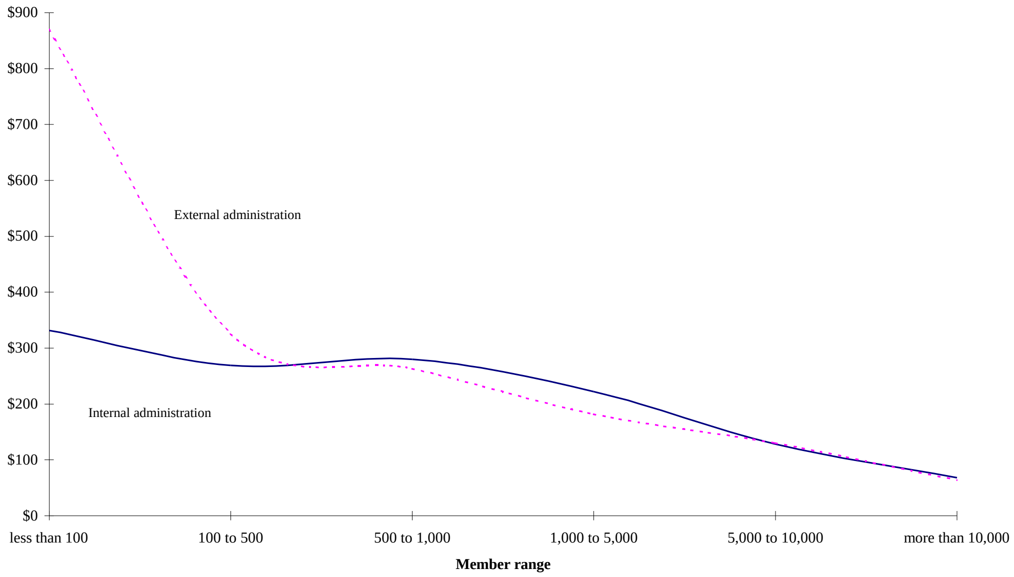
This is consistent with the finding that the main market segment serviced by the major administrators is the small to medium member sized funds.

Trustee organisational structure

More fundamental than whether the fund's administration is conducted internally or externally is the organisational structure of the fund's trustees. This is because any superannuation fund that wishes to attract members from beyond the business enterprise, corporate group or industry with which they are associated needs to have a trustee structure approved by the ISC. These trustee structures and operations are known as Approved Trustees. They are also required when the normal equal representation rules for trustees are not applicable. Retail funds, which by definition provide superannuation products to the general public, are required to have an Approved Trustee.

Most likely so that they are in a position to further broaden their membership base, say with the introduction of fund choice, and to more efficiently service their existing membership, a number of the larger industry fund trustees also have Approved Trustee status. For example, 19 per cent of industry funds (representing 31 per cent of industry fund assets and 25 per cent of industry fund accounts) now operate with an Approved Trustee. In contrast, only five per cent of corporate funds operate with an Approved Trustee, suggesting that these funds have little wish to expand their membership beyond their core employer related market. However, this result may be influenced more by the technical requirements of the SIS legislation rather than marketing reasons. See figure 4.

Figure 3: Fund operating expenses per member 1995-96



Significantly, Approved Trustees have made little impact on the excluded (small self-managed fund) market, where only four cent of funds use an Approved Trustee. In fact, in contrast to the other fund types, the small self-managed funds show the greatest use of individual trustees (at 36 per cent). This result most likely reflects the cheaper establishment costs for a small self-managed fund in having individual trustees rather than a corporate trustee and the propensity for all members to be trustees. Additionally, the provisions in their trust deed enabling them to pay benefits as pensions gives these funds t e flexibility to continue to operate in the post-retirement years, rather than just the pre-retirement years.

Figure 4: Use of approved trustees 1995-96

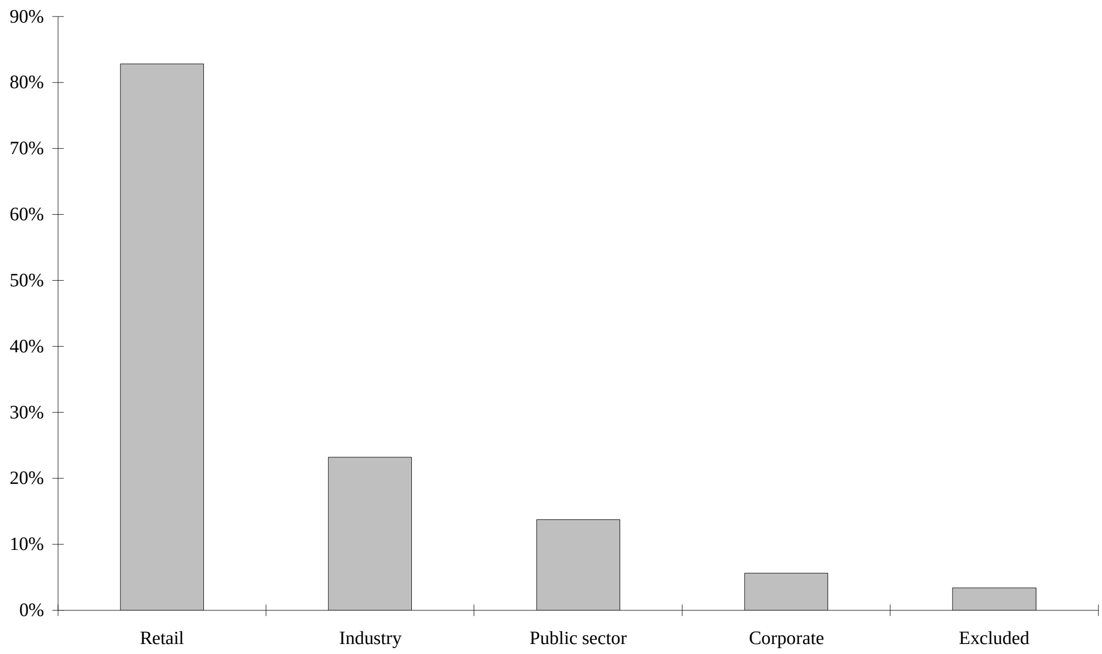
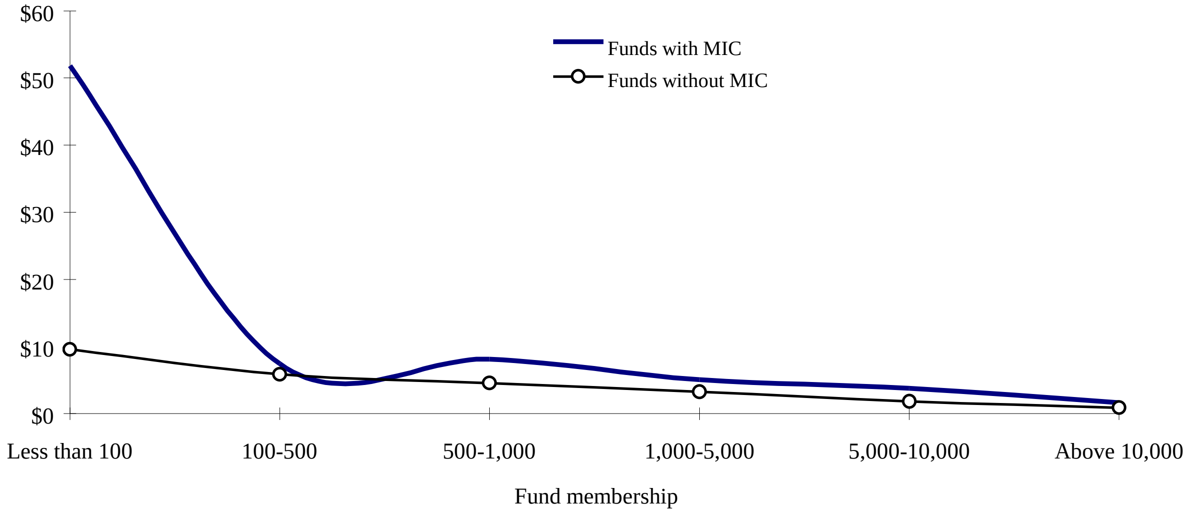


Figure 3: Weekly administration costs per member



By way of comparison, funds without member investment choice for those respective membership ranges had administration expenses of $10 per week and $0.91 per week.

Most importantly though, the gap between weekly administration expenses for funds with member choice and without member choice closes as fund membership increases. See figure 3.

Number of investment choices

While the types of investment choices may include low and high risk options with associated volatilities and likely expected returns, the average number of investment choices offered may vary considerably by fund type. Variations due to asset size are however much less significant.

The average number of choices available from all funds offering investment choice also increased very slightly during 1995-96 from 5.8 to 6.

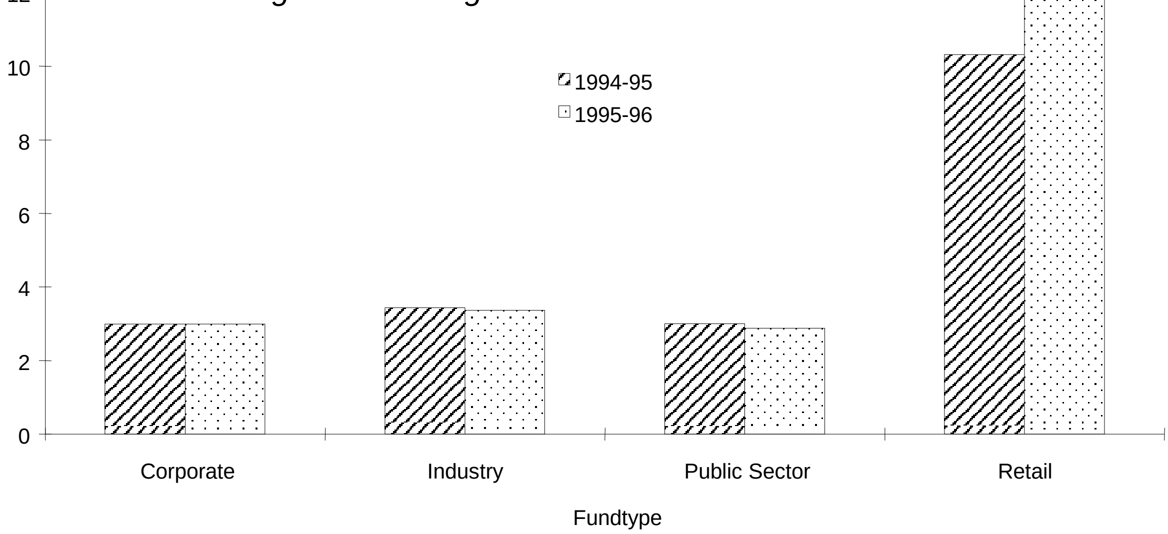
Retail funds offering investment choice average 12 investment choices while non-retail funds offering investment choice average three investment choices, most commonly a growth option, a capital stable option and a balanced option. See figure 4.

Likely future developments

While retail funds, through their product ranges and subfunds, lead the superannuation industry in implementing member investment choice, the tendency for large superannuation funds to consolidate means that the resultant larger and more concentrated funds will also have a greater diversity of membership and a greater ability to efficiently offer member investment choice.

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.

Figure 4: Average number of member choices



The Australian reinsurance market

There are 34 reinsurance companies operating in Australia's $6.5 billion reinsurance market. In this article we present an overview of this important segment of the insurance market and seek to explain some of its key characteristics.

Reinsurance is a specialised form of insurance whereby insurance companies transfer part of their primary underwriting risk, for a price, to other insurance companies. In other words, through reinsurance, insurance companies purchase their own insurance for a part of their insurance portfolio to lessen their risk exposure. Reinsurers are therefore at the end of the liability chain in the insurance market.

For example, policy holders may enter into insurance contracts with companies which can then reinsure (or cede) all or part of their insurance portfolio. A reinsurer may in turn then reinsure all or part of its portfolio of risks to another reinsurer (also known as retrocession). The policy holder need never know where the ultimate liability lies for paying up in the event of a claim being made.

If a direct underwriter cedes part of their insurance risk to an overseas reinsurer, this may have the overall effect of dividing and spreading insurable risks widely throughout the world so that the financial burden may ultimately lie outside the region in which the potential loss may occur. Because of this, reinsurance can be regarded as an international market. See figure 1.

Insurance companies choose to reinsure for a number of reasons. These may include enabling the writing of larger risks than would be viable or prudent without reinsurance, limiting the concentration of risk in a geographical area or type of business, to stabilise underwriting results, as a means of exiting a particular class of business, or simply to reduce the probability of claims exceeding total financial resources.

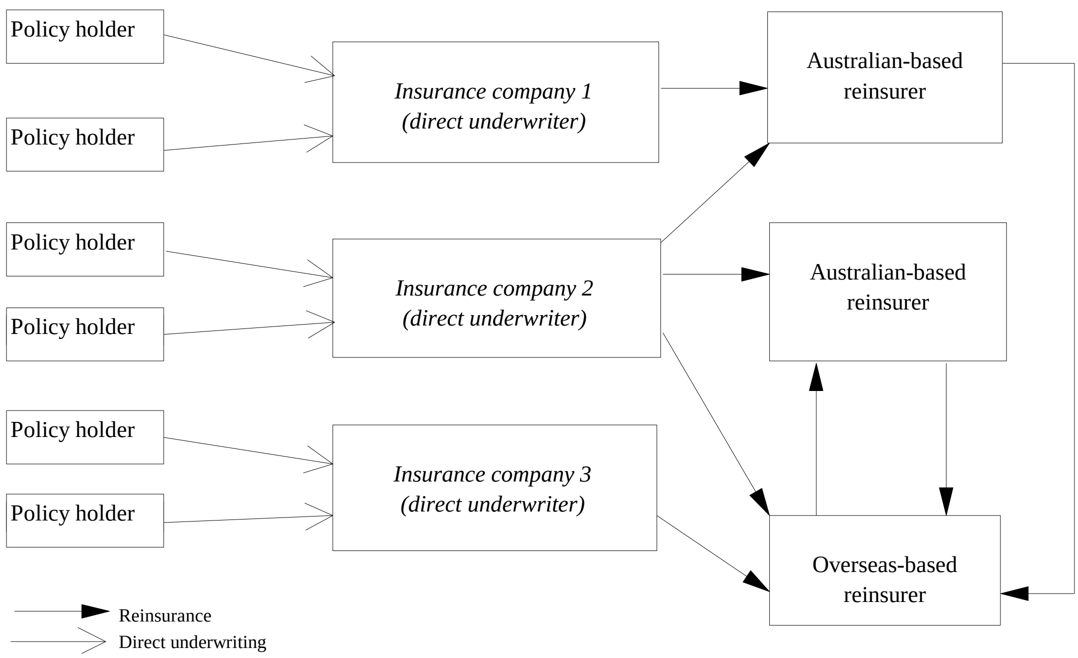
Reinsurance is one of the most complex and technical aspects of insurance. All reinsurance can be classified into two types - proportional and non-proportional. The most common forms of reinsurance used in Australia are facultative, proportional and excess of loss treaties.

Facultative reinsurance contracts are 'one-off' arrangements which help individual ceding companies insure individual risks or specific groups of risk on one policy. Proportional treaty reinsurance involves a proportional sharing of premium revenues and claims expenses between the ceding company and reinsurer. Excess of loss reinsurance contracts involve a ceding company passing on to its reinsurers the responsibility for paying losses/claims in excess of an agreed amount provided that the loss occurred as the result of a single event.

Companies

Reinsurance companies are authorised by the ISC to operate in either the general (non-life) insurance market or the life insurance market. Of the 220 insurance authorised companies operating in the combined Australian market, 34 are specialist

Figure 1: Reinsurance and the insurance market



reinsurers. These reinsurers, however, may be further categorised as 27 specialist general reinsurers and 7 specialist life reinsurers. All reinsurers are either public companies or branches of overseas companies; four are Australian owned and 30 are overseas owned. There are no pubic sector reinsurers.

The Australian reinsurance market is dominated by general reinsurers which manage 88 per cent of the reinsurance industry's assets and earn 93 per cent of all reinsurance premium. This is consistent with general insurance companies insuring larger (less predictable) risks than life insurance companies, namely financial losses caused by unforseen damage or destruction to property, accident and illness, and legal liability.

In other words, reinsurers are much more prevalent in the general insurance market than the life insurance market because of the different nature of their associated market risks.

For example, general insurance companies need to guard against large accumulations of losses arising from one event generally associated with unpredictable catastrophes. Risks for life insurance companies, on the other hand, while being much less volatile, are significantly easier to predict.

Reflecting these different risk profiles, general insurance reinsurers' assets represent 19 per cent of general insurance assets, while life insurance reinsurers' assets represent less than one per cent of life insurance assets.

The different risk profiles of these markets are further explained by the significant proportion of life insurance assets that in reality relate to investment linked and other savings products (such as superannuation) rather than risk products per se.

Due to the high degree of integration of the Australian reinsurance market into the global market, overseas owned reinsurance companies are very active in the Australian reinsurance market. At 31 December 1996, overseas owned reinsurance companies accounted for 88 per cent of all reinsurers operating in Australia and earned 81 per cent of reinsurance premium revenue. Of the overseas owned reinsurers, 29 per cent are branches of overseas reinsurers, and 71 per cent are Australian based subsidiaries of foreign corporations.

Assets and premiums

The Australian reinsurance market has $6.5 billion in assets under management, of which $5.8 billion is held by general reinsurers and $0.7 billion by life. This dominance of general reinsurers is also evident in industry premiums where in 1995-96 general reinsurers earned $1.5 billion (or 94 per cent) of the total $1.6 billion in reinsurance premiums.

The reinsurance market grew steadily over the past three years with premiums increasing at an average of 16 per cent per annum from $1 billion in 1993 to $1.5 billion in 1996. Over the same period, assets grew an average 14 per cent per annum from $4.3 billion in to $6.5 billion. See figure 2.

The growth in reinsurance premiums and assets also outpaced the overall growth in the total insurance industry. For instance, from 1993 to 1996 total insurance industry premiums and assets increased only 11 per cent per annum and 9 per cent per annum respectively.

Reinsurance premium and asset growth reflects the recent expansion in industry capacity, following a shortage of capacity at the turn of the decade, as well as the increased demand for reinsurance that will occur as the directly underwritten insurance market (or non-reinsurance) grows. However, despite another year of good results for reinsurers reflected in the reduced catastrophe rates and increased capacity in the market, the industry maintains steady growth in both assets and premiums.

Figure 2: Reinsurance assets and premiums 1992-1996

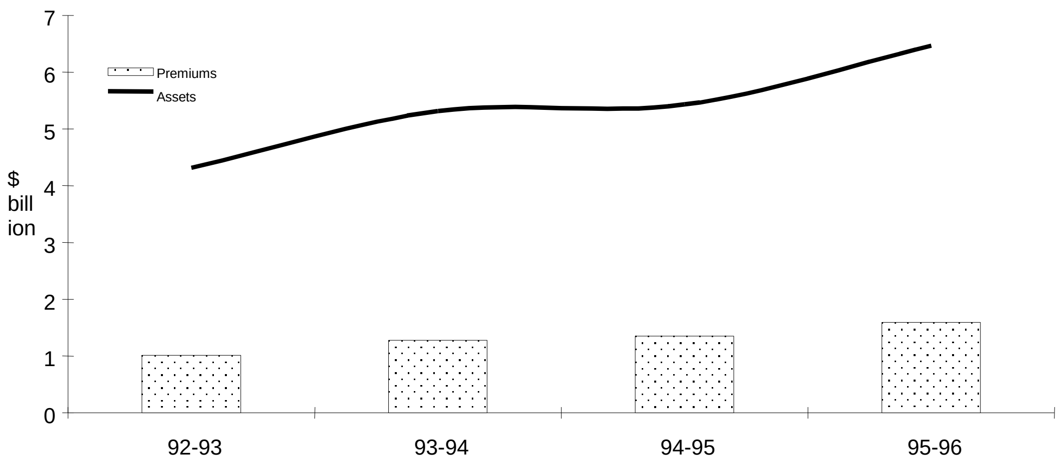
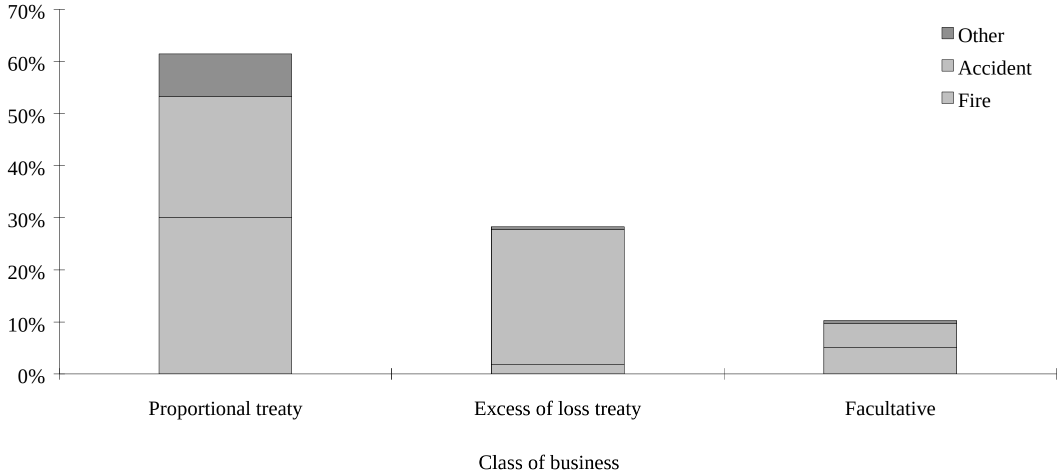


Figure 3: Reinsurance claims by class of business



Two thirds of all reinsurance premiums are paid on proportional treaty insurance. For instance, 37 per cent of all premium is in proportional treaty fire insurance, while accident and 'other' proportional treaties account for 12 and 18 per cent respectively. The majority of the remainder of premiums are paid on fire and accident excess of loss treaty reinsurance policies.

Payment trends

In 1995-96, Australian-based general reinsurers paid claims amounting to $900 million, however, almost two thirds of all claims were paid on proportional treaty claims. The highest proportion of total claims were paid on proportional treaty fire policies, followed by excess of loss accident claims and proportional treaty accident policies. See figure 3.

Over recent years, general reinsurance claims payments grew on average by 9.9 per cent per annum from $666 million in 1993 to $885 million in 1996. This claims experience compares favourably with that of general direct underwriters, where claims payments grew on average by 16.3 per cent per annum from $6.6 billion in 1993 to $10.4 billion in 1996.

The comparatively superior claims payment history of reinsurers may be explained by the lack of major catastrophes and reinsurers' more sophisticated and discretionary underwriting practices where they tend to have closer contact with their clients than direct underwriters, enabling them to be more selective in the risks they take on.

Concentration

The Australian reinsurance market is relatively concentrated with the largest 10 reinsurers holding 77 per cent of industry assets and writing 86 per cent of premiums. The largest 20 reinsurers hold 96 per cent of industry assets and write 98 per cent of premiums. See figure 4.

This concentration in the reinsurance market is higher than for the industry as a whole, where the largest 10 companies hold 46 per cent of total private sector assets and write 48 per cent of premium, and where the largest 20 companies hold 68 per cent of total private sector assets and write 69 per cent of premium.

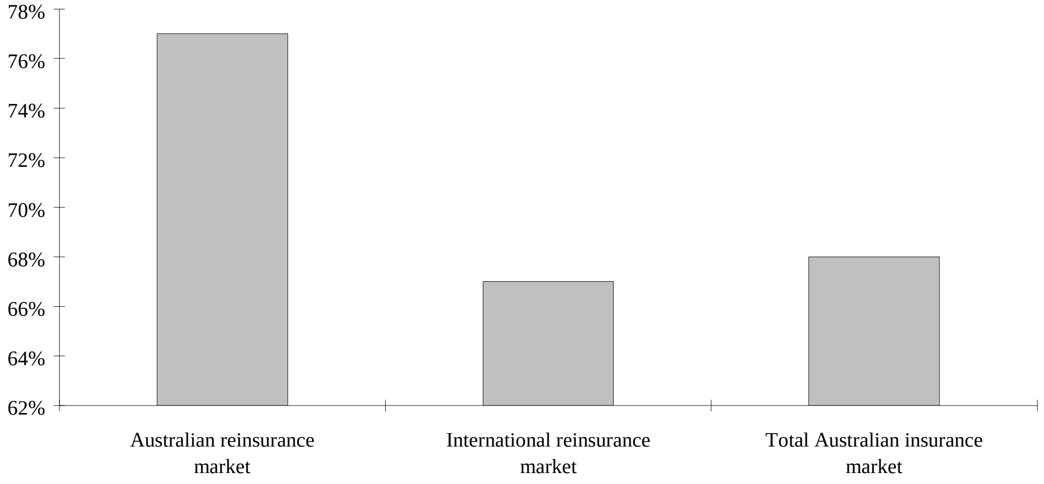
The Australian reinsurance industry is also more concentrated than the international reinsurance market where the top 20 reinsurers write two thirds of all reinsurance premiums worldwide. International reinsurance experts have predicted further concentration of the international reinsurance industry into a small number of 'mega' reinsurers as well as specialised niche reinsurers that can deliver quality products and services[1].

Profitability

In recent years the strongest influence on total insurance industry profitability has been poor investment performance, particularly following the downturn in the bond and equities market in 1994 and 1995. However, profitability in the reinsurance market in recent years has been increasingly influenced by underwriting performance, which tends to fluctuate with the occurrence of natural disasters and premium levels.

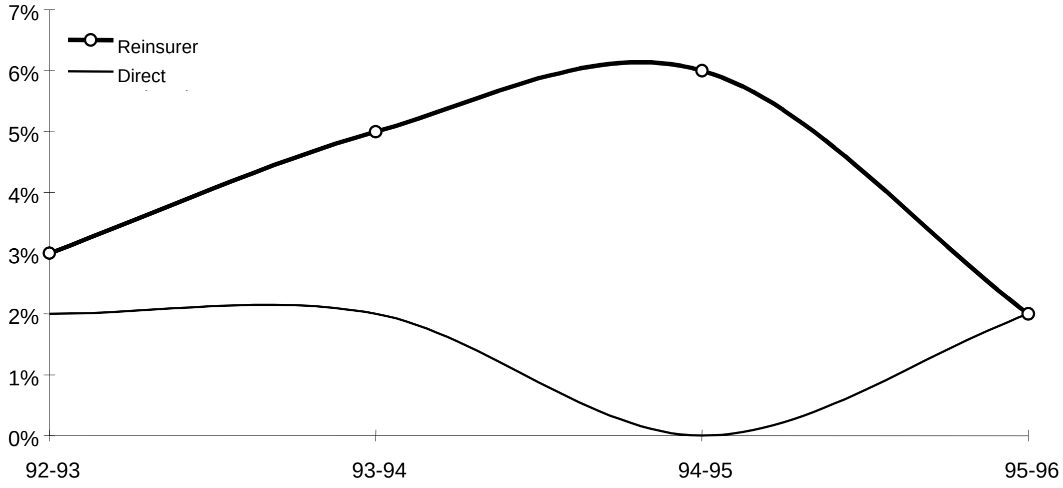
1. See "St Paul Re Chairman Predicts Further Consolidation In Reinsurance Industry", *Asia Insurance Review*, April 1997, p. 52.

Figure 4: Market share held by top 10 companies



During the last four years, reinsurers consistently outperformed direct underwriters. This perhaps reflects the comparatively more sophisticated and discretionary underwriting practices of reinsurers and the lack of any major catastrophes. However, in the 1995-96 financial year, the return on assets for reinsurers and direct underwriters converged. This has been caused, in part, by the improved underwriting performance of direct underwriters through higher premiums and attention to costs, while reinsurers have had their margins eroded though increased competition on premium rates. See figure 5.

Figure 5: Return on assets 1993-1996



Growth trends in the investment management industry

The investment management industry in Australia is growing at around 13 per cent annually. In this article we briefly review some recent growth trends in this important industry, particularly focussing on the banking and life office sectors as well as the new overseas owned wholesale managers.

The investment management industry in Australia today represents around $353 billion, and is growing at 13 per cent annually. Investment managers are the second broad type of institution in the financial system, after financial intermediaries such as banks and other deposit takers. In this article we briefly investigate some of the more significant growth trends in major sectors of this important industry.

Banks and life offices

While it is a relatively straightforward task to assess the market share of bank and life office owned investment managers today, it is much ore difficult to assess their relative position over a longer period of time. The banking group market share includes both commercial and merchant banks.

These measurement difficulties arise because of the small and medium sized investment managers have not consistently reported assets under management in industry surveys. This is compounded by the fact that many new wholesale investment managers now operating in Australia are bank subsidiaries.

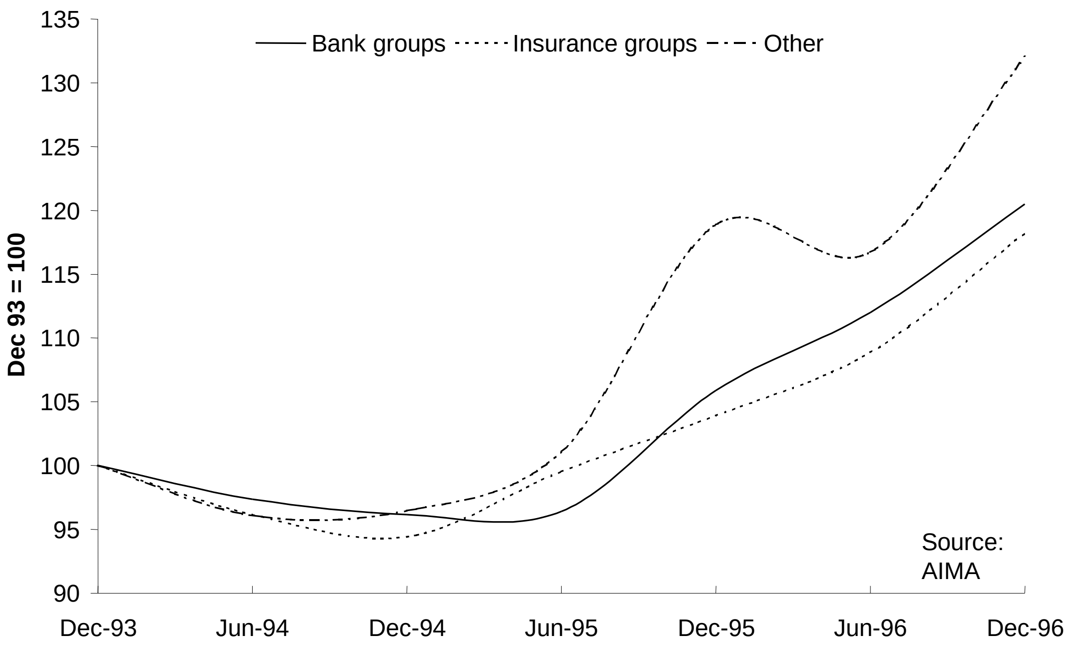
One way to overcome this difficulty may be to only count managers that have operated in Australia and reported regularly since 1993 - the period being examined. Such a strategy enables us to monitor the 55 per cent of major investment managers which now account for 93 per cent of industry assets under management. The ensuing analysis also focusses on Australian sourced funds.

Using figures obtained from regular membership surveys conducted by the Australian Investment Managers' Association (AIMA), it is clear that banking group investment managers have been growing at an overall rate very similar to that of life office group investment managers. However, other investment managers have been growing even faster. See figure 1.

Since 1993, assets managed by banking group investment managers increased at an annual average of 6.4 per cent and assets managed by life office group investment managers increased at an annual average of 5.7 per cent. In contrast, other managers' assets increased at an annual average of 10 percent.

Complicating this analysis, as mentioned earlier, is the fact that many of the new wholesale managers now entering the Australian investment market are bank subsidiaries and this has the effect of increasing the raw growth rates of the banking sector. For example, with the purchase of Axiom funds management by Deustche Bank, the banking group market share of the investment management industry will increase by around five per cent, narrowing the gap between banking and life office group investment managers even further.

Figure 1 : Investment manager assets



Moreover, some of the new wholesale managers - both Australian and overseas owned - that operate primarily in high growth markets such as equities, may be growing more rapidly not because they are necessarily more competitive but rather because their capital market produces higher returns which in turn leads to faster increases in assets under management.

Overseas owned managers

There has also been considerable interest in the impact of new overseas owned investment managers operating in the Australian market, even though the majority of the assets managed by these overseas owned managers are still invested within Australia.

After discounting 1994 which saw the market share of overseas owned investment managers increase dramatically, it appears that assets managed by overseas owned and Australian owned managers are, now increasing at around the same rate, at an annual 12.6 and 13.2 per cent respectively. See figure 2.

Again, the recent purchase of Axiom funds management by Deustche Bank will increase the market share of the investment industry controlled by overseas owned managers.

Life insurance policy trends

Another trend during the past few years in the investment management industry has been the decline in the market share of superannuation assets held in life insurance policies, which has been decreasing steadily at around 11/2 per cent annually since 1992.

And this is occurring simultaneously with the decline, relative to inflation, of non- superannuation business invested with life offices.

However, this decline relates only to monies held in life office statutory funds. It does not reflect money managed by life office groups as a whole.

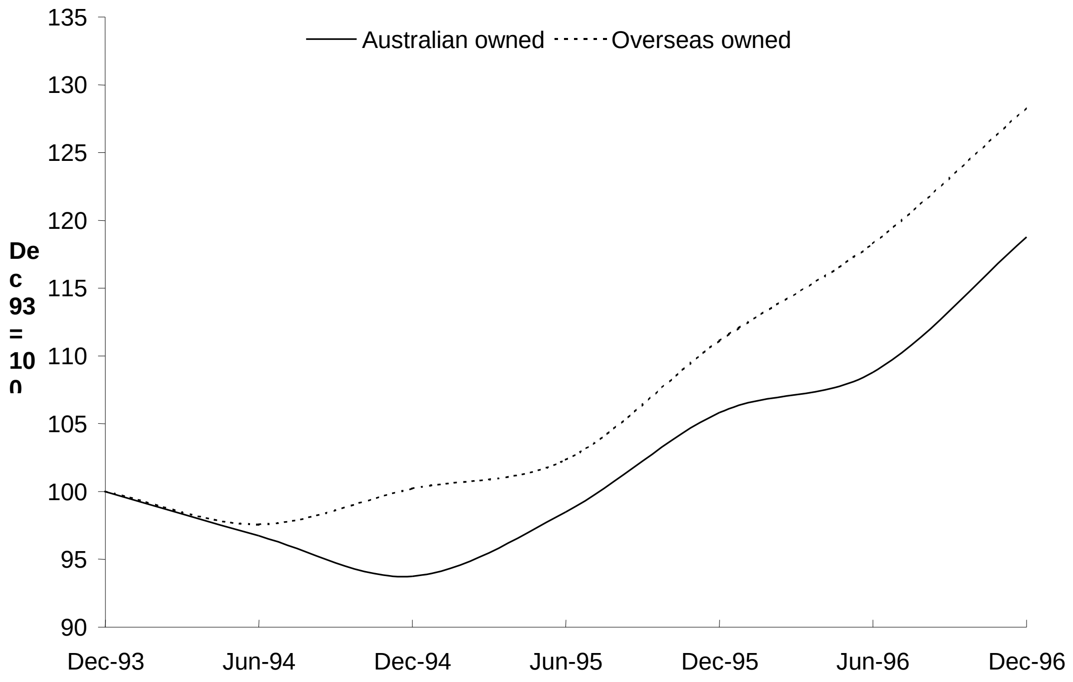
The decline in the superannuation market share of life insurance policies is in contrast to the 5.7 per cent average annual increases being experienced by life office group investment managers.

Also, while life insurance companies usually have the majority of statutory fund assets managed by a related investment manager, they may also contract out portions of their portfolio to external managers.

However, there is now a trend emerging within life offices to divert some of the new contributions and savings made by investors into specialised investment categories managed by the company's related investment manager, rather than into normal life insurance policies

For example, retail investors may be encouraged to purchase units in public unit trusts or mastertrusts, while wholesale investors may be encouraged to purchase units in wholesale unit trusts, pooled superannuation trusts or wholesale mastertrusts, or possibly (depending upon the amount of the potential placement) consider having their portfolios individually managed.

Figure 2: Assets managed by Australian and overseas owned



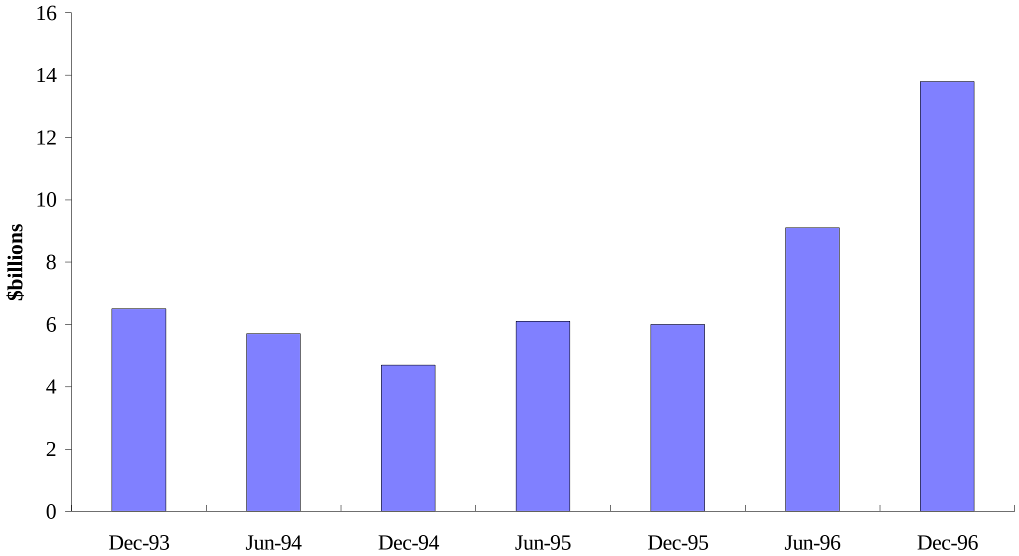
While it is difficult to precisely separate these amounts into these retail and wholesale categories, it is possible that a significant proportion may be retail as the life office group may possibly be seeking to take advantage of greater cost efficiencies available from the more straightforward structures of the group's investment managers' products, relative to their statutory fund policy structures.

Consistent with this, the estimated amount of money managed by life office group investment managers in excess of their parent's statutory fund assets has doubled within the last 12 to 18 months to an estimated $14 billion. See figure 3.

Another aspect of the changing mix of life office business is the rapid growth in unitised investment linked business within life office statutory funds (growing at an annual 18 per cent) and the decline in real terms of noninvestment linked traditional and capital guaranteed business within life office statutory funds (only growing at an annual one per cent).

While this shift in investment focus within life office statutory funds does not relate to any possible increased promotion of products offered by the related investment manager rather than the life office itself, it does illustrate that life offices are increasingly offering non-traditional products that more closely resemble products offered by investment managers.

Figure 3: Life insurance groups' non-statutory fund assets



Superannuation survey highlights - March 1997

Main features

- By end March 1997, total superannuation assets had reached $279.5 billion, representing growth of 2.4% during the quarter, or 10% annually.
- Contributions this financial year are on track to be around 14% higher than they were in 1995-96.
  - however, around 40% of this increase was possibly due to the increase in the minimum SG amount paid by small business on behalf of their employees (which increased from 5 to 6% of salary in 1996-97).
- Total contributions during the quarter were again around $7 billion, of which 65% were paid by employers and 35% by employees.
- The number of superannuation accounts increased during the quarter (up 300,000 or 1.8%). The increase represents a return to the usual pattern after the 'cleansing' of erroneous account records that occurred last quarter. There are now nearly 16.4 million accounts.
- Account turnover during the quarter was around 1.4 million (over 8% of all accounts). This includes the creation of 840,000 new accounts and the closure of nearly 550,000 old accounts.
- Growth in superannuation fund assets during the March quarter can be disaggregated into net deposits (accounting for 67% of the growth) and net earnings (accounting for the remaining 33% of growth). This result represents a reversal from last quarter, mainly brought about by the flat performance of the investment markets during the March quarter.

Industry structure

Small self-managed schemes' (ie, excluded funds with less than 5 members) assets again grew fastest during the March quarter, increasing by 5% ($1.4 billion). This rate of increase was closely followed by the 4.7% ($800 million) growth in industry fund assets. Retail assets grew by 2.9% ($1.9 billion). Trailing these market segments were public sector fund assets (increasing by 1.6%, or $1 billion) and corporate fund assets (which grew by only 0.1%, or $80 million during the March quarter).

Retail funds currently hold over 24% ($67.5 billion) of total superannuation assets, public sector funds hold 23% ($64.8 billion), corporate funds 21% ($58.4 billion), excluded funds nearly 11% ($29.2 billion), and industry funds 6% ($17.6 billion). The remaining 15% ($42.1 billion) of superannuation assets represent annuity products, fund reserves and unallocated profits of life office statutory funds.

Contributions and benefits

During the March quarter, employers contributed $4.4 billion into superannuation while employees contributed $2.4 billion. Inward transfers accounted for 35% of all money deposited into superannuation during the March quarter.

Lump sums, excluding outward transfers, accounted for 78% ($3.1 billion) of the benefits paid during the March quarter. The remaining 22% ($0.9 billion) of benefits were paid as pensions. Outward transfers accounted for 43% of all fund withdrawals during the March quarter.

Contributions into superannuation are now growing at around the same rate as total superannuation assets. Contributions during the first three quarters of 1996-97 were up by 14% compared to the first three quarters of 1995-96, while annual growth of superannuation assets to March 1997 was also 14%.

Benefit payments are growing at a slower rate than contributions. Benefit payments, excluding transfers, for the first three quarters of 1996-97 were up by 9% compared to the first three quarters of 1995-96. The lower growth rate of benefit payments as compared to contributions has had the effect of net contributions (i.e., contributions less benefits) being 25% higher for the first three quarters of 1996-97 as compared to 1995-96. In other words, significantly more money is flowing into superannuation than is flowing out.

Manner of investment

In a change from previous quarters, the superannuation assets invested in life office statutory funds showed the strongest growth during the quarter, increasing by 3.2%. Assets directly invested by trustees, a style of investment becoming more popular among small and large funds alike, also grew strongly at 2.8% during the quarter.

In contrast, the value of placements with investment managers had the slowest growth at only 1.4%. This might be explained however, by the fact that of the three styles of investment, investment managers hold by far the greatest proportion of their assets in equities (at 37%) and that the Australian equities market performed relatively poorly during the quarter. Thus the relative growth in assets can diverge from deposit trends.

However, at the end of March 1997 investment managers still held 40% ($110.8 billion) of total superannuation assets, with the statutory funds of life offices remaining at 37% ($104.5 billion). The remaining 23% ($64.2 billion) of superannuation assets are directly invested.

Asset allocation

Superannuation assets invested overseas decreased slightly to 15.8% at the end of March. The increase in the TWI of 1.9% during the March quarter (acting to automatically decrease the AUD value of overseas investments) was only slightly offset by trustees investing an additional net $740 million overseas during the quarter.

Superannuation investment in equities increased marginally (by 1.6%) during the March quarter. Since the ASX accumulation index moved negligibly (up 0.1%) during the quarter it follows that there was a net flow of around $1.1 billion into the equities markets by superannuation funds. Superannuation equity holdings remain at 28% of total superannuation assets.

Holdings of long term debt securities decreased by 0.7% ($300 million) during the March quarter, in line with long term bond yields rising from 7.4% to 8.0%. The proportion of superannuation assets held as long term debt securities remains at 17%.

Holdings in short term debt securities rose by 3.8% ($875 million) during the March quarter, despite the rise in short term yields from 6.0% to 6.8%. Even so, the proportion of superannuation assets held as short term debt securities remains at 9%.

These movements would appear to indicate that during the March quarter superannuation funds were net purchasers of Australian equities, overseas assets and short term debt securities. In contrast, they were net sellers of long term debt securities. This result suggests that while demand for growth assets remained relatively strong, despite the overall flat performance of the equities market, during the quarter money was also moved into short term debt securities perhaps awaiting clearer signals from the longer term markets.

Reinforcing this, the proportion of superannuation assets invested in cash, deposits and placements also rose (to 10%). Unit trust holdings increased to 11%, while assets held in direct property remained steady (at 6%). Other investments accounted for around 3% of total superannuation savings.