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# **Informed superannuation choice: constraints and policy resolutions**

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# **Informed superannuation choice: constraints and policy resolutions**

## **Abstract**

The latest controversy to emerge in Australia's ever-changing superannuation system is the failure of the proposed 'member choice of fund' legislation. While superannuation choice continues to be widely supported, the debate lacks coherent policy direction. This paper addresses the policy hiatus by developing a framework to systematically examine endogenous and exogenous constraints affecting the achievement of informed choice, members' choice preferences and associated policy resolutions. Applying this framework, we argue that a genuine choice of fund model should cater for active and passive choice, where passive choice applies to fund members who, for various reasons, are unwilling or unable to make active choices. Appropriate education programs and standardised disclosure are identified as critical prerequisites to enable informed choice by those members who want to actively participate in the management of their superannuation savings. To protect the interests of passive choice members, we suggest the option of a government-regulated universal default fund (UDF).

## **1. INTRODUCTION**

The latest controversy to emerge in Australia's ever-changing superannuation system is the recent failure of the 'member choice of fund' legislation. Superannuation choice issues were raised by the Coalition Government in the mid 1990s when it was contended that government had a responsibility to simplify the superannuation system and, ensure fund members have access to greater flexibility and more choice of superannuation fund investments (Short 1996). At that time most occupational funds did not compete for members, relying instead on government mandate to operate as a monopoly (Gallery, Brown and Gallery 1996). Offering choice has been promoted as a positive policy option, giving members more control over how their superannuation savings are managed, increasing competition in the superannuation industry, which in turn, is expected to result in an increase in members' benefits (ISC 1998). However, we argue that there are significant constraints in achieving informed choice for *all* super fund members.

In this paper we develop a framework to examine endogenous and exogenous constraints affecting the achievement of informed choice, conceptualise members' choice preferences and provide associated policy resolutions. Applying this framework, we argue that a genuine choice of fund model should cater for active and passive choices, where passive choice applies to fund members who, for various reasons, are unwilling or unable to make active choices. To protect the interests of passive choice members, we recommend the option of a government-regulated universal default fund (UDF).

## **2. BACKGROUND ON SUPERANNUATION CHOICE**

Australian employer-sponsored superannuation schemes have operated traditionally with little or no choice available to employees regarding which scheme they join, the types of benefits (defined benefit or accumulation) provided, or alternative investment strategies for their savings. The Federal Conservative Government sought to change this situation with their policy to provide employees with a choice of superannuation fund. The Government's choice of fund policy was originally announced during the 1996 election and then formally presented the details of its choice of fund proposals in the 1997 Budget (SSCS 1998). In its report on the inquiry into the Australian financial system, the Wallis Committee also

recommended that superannuation fund members should have greater choice of fund (Wallis 1997). The primary objective of the Government's policy "was to provide greater freedom of choice for superannuation contributors and greater competition between funds", which is expected to lead to "reduced costs and increased returns" (SSCSFS 2000, para. 1.1).

Choice of fund legislation was first introduced to Federal Parliament in December 1997 and underwent several iterations of amendments. During the development of the proposed legislation there was considerable debate and controversy about the model (type and form) of choice that is appropriate within the Australian superannuation system. A consensus could not be reached and ultimately, on 8 August 2001 the Senate rejected the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 1998. The major political parties support the concept of choice, but ideological differences appear to influence their preferred choice model.<sup>1</sup>

Although the choice of fund legislation failed, choice remains a relevant issue for superannuation. Prior to the Government's initiative to legislate for between-fund choice, many superannuation funds were already offering their members choices by allowing them to choose an investment strategy from a limited range of options.<sup>2</sup> The Choice Bill provided added impetus for superannuation fund trustees to offer more choices to members during the three and a half years that the Bill was 'on the table'. In particular, the choice debate focused attention within the superannuation industry on fund performance, and consequently, many funds began to offer varying levels of choice to their members.

Given that superannuation fund members increasingly face choices, many critical issues associated with choice remain unresolved. In particular, informed choice is dependent on members' motivation and ability to exercise choice, the financial expertise of members, and adequacy of disclosure of superannuation fund information.

### **3. A FRAMEWORK FOR SUPERANNUATION CHOICE**

While government mandates compulsory superannuation savings through Superannuation Guarantee (SG) contributions, the system is situated wholly within the

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<sup>1</sup> The Labor Party opposes between-fund choice and instead advocates within-fund investment choice (Senate Hansard, 8 August, 2001, p.25822). The Democrats were in fact prepared to support the proposed legislation but as a trade-off for their support demanded that the Government address the issue of same-sex couple rights to access superannuation benefits (Senate Hansard, 8 August 2001, p. 25831). As the Government was not prepared to concede to the Democrats demands, the Bill was defeated.

<sup>2</sup> In 1996-97, 11% of non-retail funds offered their members investment choice (ISC 1998).

purview of the private sector. There are several issues in relation to superannuation ‘choice’ in this context. First, government does not underwrite vulnerabilities of the system, except by enacting legislation to re-regulate following market failure. The protection of members’ retirement benefits becomes reliant on a set of checks and balances that have been shown to be inadequate. The regulatory environment is largely aimed at ensuring superannuation providers meet their fiduciary obligations. Government action in this regard has been largely reactive to repair anomalies and correct abuses to the system. Second, the notion of public interest is unable to be invoked satisfactorily in relation to those who are less powerful stakeholders in a private sector-based superannuation system. Balancing the interests of a range of wage earners with those of shareholders and other institutional players is problematic in a private market context where concern for the ‘bottom line’ takes precedence over social and equity considerations. Third, there is an assumption that the provision of education programs will enable employees to make better choices in relation to the superannuation system. However, we argue that while education in superannuation matters is an important consideration, education alone cannot solve all the issues faced by employees with regard to an increasingly complex superannuation system. Other endogenous and exogenous constraints that hinder employees’ choice decisions need to be addressed before a genuine choice model can be successfully implemented that will enable workers to maximise their retirement income. Figure 1 presents a framework of superannuation choice outlining the concept of genuine choice.

As shown in Figure 1, the primary objective of superannuation fund members is to maximise their retirement income. In a choice environment, achievement of this objective is heavily reliant on members making informed choices. However, a range of endogenous and exogenous constraints imposes limitations on informed choice. Endogenous constraints include such factors as members’ unwillingness or inability to become informed and ‘risk transfer costs’ such as the cost of becoming informed, the cost of not becoming informed and the cost of making a wrong choice. Exogenous constraints arise from information asymmetries between fund members and fund trustees and other agents involved in the investment management and administration of the superannuation fund, leading to severe moral hazard problems.

Given these constraints, a genuine choice of fund model would cater to both those members who want to make an active choice and those who prefer not to exercise that choice. That is, genuine choice concerns the right to make an active choice to participate in

decisions about investment of superannuation savings or to choose to opt out of this decision-making process. For those who choose active choice, a range of mechanisms regarding disclosure and education are needed to support achieving informed choice. For those who choose to opt out, providing a government-regulated universal default fund would ensure that members' benefits are secure and their interests are protected. In this context, a choice of fund model should offer unlimited fund options together with a secure universal default fund. We argue this represents genuine choice.

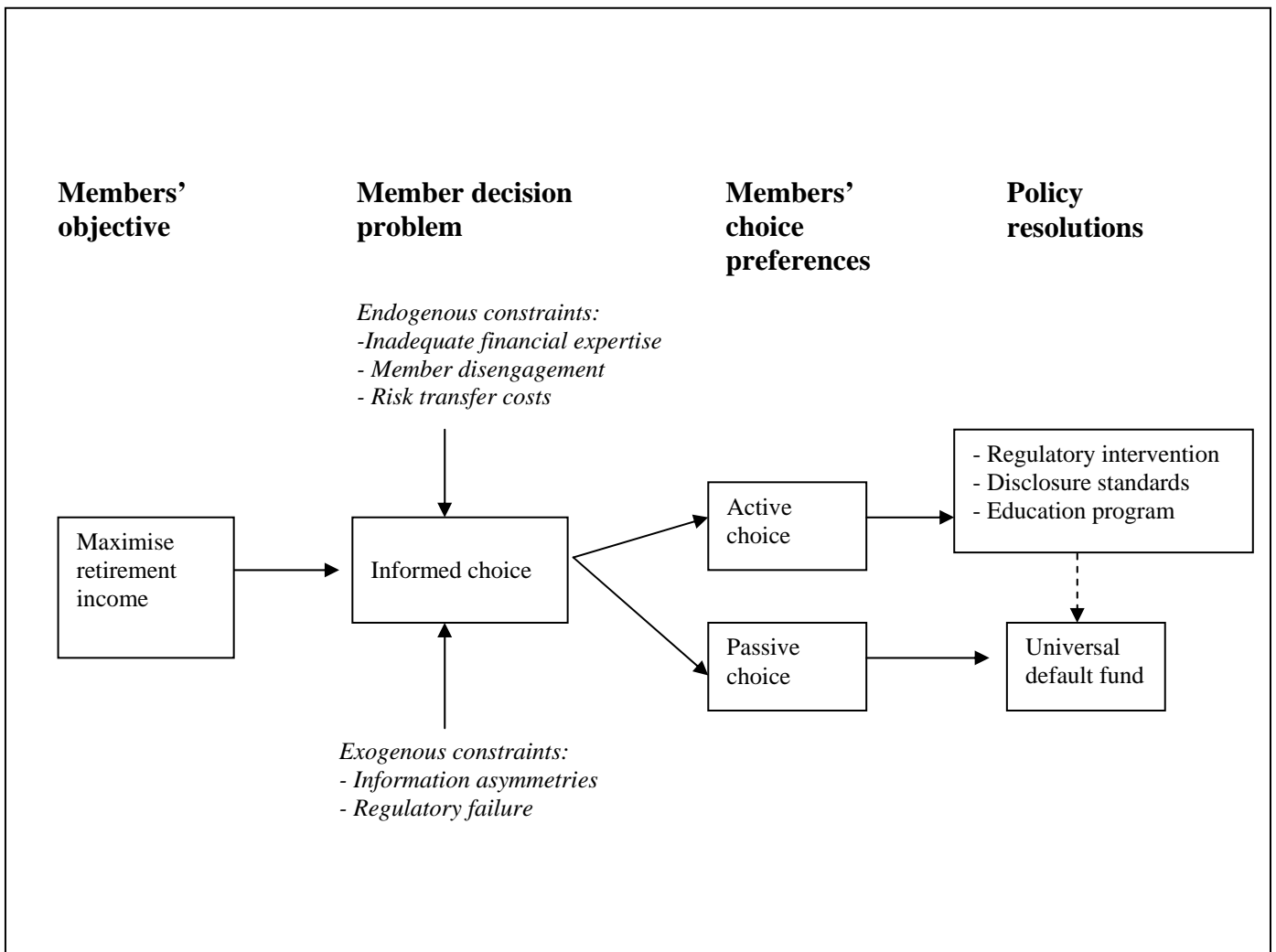


Figure 1 Superannuation Choice Framework



## **4. ENDOGENOUS CONSTRAINTS ON INFORMED CHOICE**

Endogenous constraints are those that are employee specific and as a consequence, differentially affect employees when faced with a choice decision. They include inadequate financial expertise, member disengagement, and risk transfer costs (costs to members).

### **4.1 Inadequate financial expertise**

A certain level of financial literacy is essential to evaluate and monitor performance of alternative superannuation funds. In choosing a superannuation fund, members are faced with the tasks of examining, comprehending and evaluating an array of fund information to assess their relative merits. This process includes evaluating the nature of each fund's investment strategy, investment portfolio, and the expected investment risks and expected returns to determine the best match to members' risk-return preferences. Two additional complexities faced by members are the various fee structures (entry, exit, management, investment fees) and potential effects of those fees on net returns, and comparative value of additional products offered, such as life and disability insurance. Many superannuation fund members do not have the financial knowledge or skills to perform such tasks. For example, ABS statistics show that 46% of Australians have "unsatisfactorily low levels of literacy" and 15% are "functionally illiterate" (SSCSFS 2000, para.4.16). AMP Financial Services suggested that the implication of this is "that there is going to be a percentage of the population who will never understand the concepts involved" (SSCSFS 2000, para.4.16). In the absence of impartial advice, these fund members are unlikely to benefit and, in fact, risk being worse off in an unregulated choice system.

The Government, superannuation industry and community groups recognise the need for a 'fund choice' education program. However, the amount and source of program funding represents a major obstacle to providing effective member education. In the Senate Select Committee on Superannuation (SSCS) *Choice of Fund* report the Government Senators acknowledge the role of government in educating members. Nevertheless, it is anticipated that the private sector (the superannuation industry) will play a significant role in the process (SSCS 1998, para. 14.2). According to the Association of Superannuation Funds of Australia (ASFA) the estimated education budget needed to prepare existing members for a choice

environment would be in the vicinity of \$40 million, and half of this amount should be paid by government (SSCSFS 2000, para. 4.28).<sup>3</sup>

A major concern about the superannuation industry dominating the education process is the danger that it will become a marketing exercise by superannuation providers (as occurred in the U.K.) rather than providing a genuinely independent and objective education program. The U.K. experience is a lesson in how large numbers of employees can be lured away from sound company pension plans by unrealistic promises, and as a result suffering “considerable financial detriment” (SSCS 1998, para. 11.4.). Furthermore, in the absence of ongoing government funding, the need for updating members on the frequent and often complex changes to superannuation and investment products is likely to be increasingly assumed by the superannuation industry in pursuing the industry’s vested interests. Even if a member education program is adequately funded, an objective education program is implemented, and members are willing to participate in the program, it will still take a considerable period of time to bring members up to an adequate level of financial expertise.<sup>4</sup> Moreover, member education in superannuation matters will necessarily be ongoing and the issue of the associated significant costs and who bears those costs has not been addressed in the choice debate.

In combination, these obstacles do not augur well for the general expectation that all members have the capacity to develop and maintain sufficient expertise on an ongoing basis to make an informed superannuation choices.

#### **4.2 Member disengagement**

The effectiveness of a superannuation choice system and any associated education program is limited by the extent of participation by fund members. When faced with the complex investment decisions inherent in a superannuation choice system, individual attitudes towards participation are likely to vary considerably. Those who choose to avoid participation will remain effectively disengaged from the process.

Braithwaite and Braithwaite’s (2000) ‘enforcement pyramid’ model is useful in conceptualising the continuum of superannuation fund members’ attitudes to superannuation

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<sup>3</sup> This estimated budget is unlikely to address the shortcomings of member’s basic literacy and numeracy skills.

<sup>4</sup> According to AMP Financial Services, “if the experience in the U.S. is a guide, it would take in the order of 10 to 15 years for the population to reach a stage of financial literacy” (SSCSFS 2000, para. 4.34).

fund choices.<sup>5</sup> Braithwaite and Braithwaite (2000) argue that education, persuasion and understanding can work to secure a willingness to comply with regulation imposed by the taxation system. However, those categories of wage earners who are either resistant to complying, or have become disengaged from the process will only comply in a system of ‘command regulation’ (Braithwaite and Braithwaite 2000). Applying this concept to the ‘superannuation choice’ context, it is erroneous to assume that all superannuation fund members are able and/or willing to develop their skills to a level sufficient to exercise informed choice.

Member disengagement already represents a major problem for retirement income for many Australians. Statistical and survey findings provide considerable evidence of widespread disengagement within the superannuation system. Changes to labour market structures contribute to the problem of disengagement in that the growth of casual jobs has increased the risk of workers losing track of their superannuation entitlements. For example, a survey conducted by ASSIRT and Challenger International found that up to 50% of workers are unsure of which fund their superannuation contributions had been directed (Lampe 2001). Similarly, an earlier Newspoll survey found that 64 percent of fund members had little or no knowledge of their funds. Further, only a quarter of fund members read some or all of the annual fund report, and only 43 percent of those were able to recall some information detailed in the report (Kavanagh 1998).

A possible reason why members become disengaged and are slow in taking up available choices is because they “would not be generally interested in investment choice until they have accumulated a reasonable balance in their accounts” (SSCSFS 2000, para. 8.23). This is evident in three interrelated areas associated with multiple small balance holdings, namely small account balances, lost members and unredeemed superannuation guarantee vouchers.

A survey of 153 funds in 1995 found that those funds held 1.4 million accounts with small balances, which represented 35 percent of the membership of those funds (Fletcher, 1995, p.43). It is likely that since then the small accounts balances problem has grown and

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<sup>5</sup> Braithwaite and Braithwaite’s (2001) model of an ‘enforcement pyramid’ demonstrates that there are a range of differing attitudes to tax compliance, and consequently, a range of corresponding strategies that should be deployed to deliver the required tax paying outcomes. Potential taxpayers are categorised from ‘willing’ to ‘averse’, and the compliance strategies vary from ‘voluntary’ to ‘enforced’.

remains an issue due to statutory protection of balances in such accounts.<sup>6</sup> According to a review of the SIS legislation, there are still concerns among fund trustees and administrators regarding costs and equity issues associated with small balances (Productivity Commission 2001, p.66). Related to the small account balances problem is the issue of lost members. There are currently around 4 million accounts on the ATO's lost members register, which represent about 18% of total superannuation accounts, containing about \$5.5 billion; this represents close to \$1,400 per account (Productivity Commission 2001. p.66).

As at April 2001 the Australian Tax Office (ATO) held \$96 million of superannuation payments, representing 403,273 superannuation fund entitlements in the form of Superannuation Guarantee vouchers<sup>7</sup> not redeemed by employees (SSCSFS 2001a). This figure represents 36% of the total value of vouchers issued. These data represent a significant amount of forgone savings and, importantly, forgone superannuation earnings for workers. Moreover, in cases where the vouchers were redeemed, the ATO found that 50 percent of voucher recipients do not understand the purpose of the voucher or what they needed to do with it (SSCSFS 2001a). While education is an important element of bringing the existence of unredeemed vouchers to the attention of workers, the approach of issuing vouchers then requiring workers to 'cash in' those vouchers by converting to a superannuation fund is unnecessarily complicated and involves a myriad of different schemes.

Both the number and total value of unredeemed SG vouchers is continuing to grow. Based on ATO statistics (SSCSFS 2001a), the average amount of unredeemed vouchers is \$238 compared with claimed vouchers averaging \$426. This again highlights the problem of small balances that often leads to workers being separated from their superannuation. This is likely to differentially affect workers, impacting adversely on those who are vulnerable in the labour market, including atypical working arrangements, marginalised industry sectors and itinerant workers. Clearly, the unredeemed vouchers issue illustrates a significant level of member disengagement which would be further exacerbated in an unregulated choice environment if left unresolved. In the absence of 'command regulation' to safeguard their

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<sup>6</sup> Under the SIS legislation trustees are required to protect members' benefits with balances less than \$1,000. This protection is either to charge no admin fees while the small account is held by the fund, or to roll over the small account to an Eligible Rollover Fund or the Superannuation Holding Account Reserve (SHAR) operated by the ATO.

<sup>7</sup> Enforcement action taken by the ATO against employers who fail to make SG contributions includes collection of the unpaid contributions and holding them in the form of a 'voucher' until the members to whom the entitlements belong can be found.

superannuation benefits, wage-earners who have become disengaged from the complex superannuation system are vulnerable to exploitation and mismanagement of their superannuation savings and are likely to remain disenfranchised from the system.

#### **4.3 Risk transfer costs**

Evidence shows that many members when given opportunities to make a superannuation investment choice fail to exercise the choice.<sup>8</sup> A common conclusion is that the failure to exercise choice is due to a lack of skills, education, capacity or desire to make a choice about their investments.<sup>9</sup> However, remaining with a 'default' option may in itself be a deliberate member choice. For example, in a study of choice by Australian academics, Brown, Gallery, Gallery and Guest (2001) found that 'risk transfer costs' rather than knowledge explained many members' decisions not to exercise choice.

The Brown et al. (2001) findings reveal that when faced with the decision to choose between a defined benefit plan (DBP) and an employer sponsored accumulation plan (with investment options) many members opted to remain in the DBP to avoid incurring the costs associated with the accumulation plan. In DBPs, sponsoring employers promise to provide a certain level of benefits when employees retire (or otherwise cease employment). Accordingly, employers bear the risk that benefits will cost more than expected (actuarial risk) and the risk that invested plan assets will generate insufficient returns (investment risk); employers thus effectively underwrite the plan (IASC 1996).

In contrast, the obligation of employers sponsoring accumulation plans is limited to an agreed contribution rate, and thus an employer's liability to provide promised benefits is discharged when periodic contributions are made to the plan. Members' benefits in accumulation plans comprise contributions and investment returns, which means that members bear the actuarial and investment risks. Additionally, members incur the costs of becoming sufficiently informed for the purposes of making the initial choice and ongoing monitoring costs. Such costs include the time taken to acquire, read and interpret relevant material, attend training sessions, and to seek professional advice from financial experts.

Thus, in accumulation plans (the most common offered in Australia), the recurring costs associated with actuarial risk, investment risk, investment selection, and monitoring,

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<sup>8</sup> Jacques Martin Industry Funds Administration provides administration services to superannuation funds with a total of approximately 2.6 million accounts. Most of the funds offer investment choice but only about 15,000 members made a deliberate choice (SSCSFS 2000, para. 8.7).

<sup>9</sup> See for example the comments by Senator Hogg, Senate Hansard, 8 August 2001, p.25827.

effectively transfer to the fund member. In a choice environment (where the choice is between fund/investment options within accumulation plans), these ‘risk transfer costs’ will be continually reassessed by fund members in their decision models and only where the benefits justify the cost will a switch be executed. For example, a fund member’s decision rule may be to stay in a default fund and avoid the risk transfer costs until the fund’s return is below the mean yearly return for funds in a similar risk-return category. If this occurs, the member then switches to alternative investment option and chooses to incur the associated risk transfer costs in exchange for the expected additional returns. From a member perspective, the choice option has a value which will increase with the available investment options, the frequency that choice can be exercised, and will decrease with any switching costs charged to the member.<sup>10</sup>

## **5. EXOGENOUS CONSTRAINTS ON INFORMED CHOICE**

The three types of endogenous constraints discussed in the previous section impact on fund members to varying degrees. Even if all these constraints can be effectively addressed, the exogenous constraints of information asymmetry arising from multiple agency problems remain a pervasive problem confronting all employees in a choice environment. These problems are compounded by regulatory failures in the extant regulatory regime.

### **5.1 Information asymmetry and multiple agency problems**

Much of the complexity in the superannuation system arises from the web of inter-relationships among various participants within the system. From an agency perspective, fund members are the principals with trustees acting as their agents. Trustees are responsible for managing and safeguarding superannuation assets on behalf of members until such time as members cease employment and become eligible to receive superannuation benefits. Trustees frequently engage other agents, such as investment consultants, external administrators and fund managers to assist with the management of the fund’s assets. Additionally, under SIS legislation, trustees are also required to engage auditors to conduct financial and compliance audits at least annually.

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<sup>10</sup> Consistent with option pricing theory (Black and Scholes 1973, Smith 1979), the choice option has a value which is clearly recognised by many fund members. For example an ASSIRT Investor Market Trends Survey found that 83% of investors considered the choice-of-fund legislation to be a good or great idea (“Investors endorse choice of fund”, *Superfunds*, June 2000, p.5).

These layers of agents give rise to multiple agency problems (Lakonishok, Shleifer and Vishny 1992, Gallery et al. 1996) in which the monitoring of agents is complicated by substantial information asymmetry. For example, if a fund's actual performance is below members' expectations, the cause of the poor performance may be due to the failure of one or more of the agents. That is, failure may be due to trustees' poor choice of investment consultant, the investment consultant's poor recommendations in the selection of fund managers, the fund managers' sub-optimal selections of investments in their portfolios, inferior company management (in the case of equity investments), or any combination of the above. Although trustees are ultimately responsible for fund performance, information asymmetry arising from the multiple agency relationships provides trustees with opportunities to distance themselves from disappointing investment returns by blaming advisers and fund managers for poor decisions (Gallery et al. 1996).<sup>11</sup> In a choice environment where investment decisions transfer to members, trustees and other agents have additional opportunity to shift blame for poor investment decisions to members. That is, the principals (members) bear the associated risk transfer costs for their poor investment decisions.<sup>12</sup>

Information asymmetry resulting from agency relationships clearly presents a major moral hazard to fund members. As in all agency relationships, effective monitoring and control mechanisms are necessary to mitigate the costs arising from this moral hazard problem. These costs include agents reducing effort, shirking their responsibilities, excessive remuneration, and over-consuming perquisites (Alchian and Demsetz 1972, Jensen and Meckling 1976, Fama 1980). However, many of the common control mechanisms that have arisen in capital markets to minimise agency costs are not evident in the current superannuation system (Gallery et al. 1996).<sup>13</sup> Fund members' major mechanism for mitigating agency costs is through the threat of terminating the services of agents for

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<sup>11</sup> Similarly, Lakonishok et al. (1992) suggest that multiple agency problems explain why U.S. pension fund sponsors prefer to employ external fund managers who adopt 'active' investment strategies. This preference persists despite evidence that active management leads to net returns below passive benchmarks. Australian evidence is also consistent with superannuation fund trustees preferring a similar approach to active fund management and incurring the associated costs and lower returns. (See Sawicki, 2000; Sawicki and Ong, 2001, Drew and Stanford, 2000, 2001).

<sup>12</sup> This ability to transfer some responsibility for poor investment decisions to members may partially explain why the superannuation industry has been voluntarily introducing limited investment choice.

<sup>13</sup> These measures include performance-based remuneration contracts between shareholders and managers, the threat of dismissal of managers, the threat of takeover, and the threat of bankruptcy, which may lead to managers risking job loss and damage to their reputation in the managerial labour market.

unsatisfactory performance.<sup>14</sup> Consequently, effective performance monitoring by fund members is critical, but performance monitoring depends on the adequacy of the information disclosed by agents.

## 5.2 Disclosure of Adequate Information

Protection of members' superannuation interests under the prudential framework of the Australian superannuation system relies "... on a well informed membership with the right to participate in managing the affairs of their fund" (Dawkins 1992, p. 1). Disclosure of adequate and appropriate information enables members to exercise influence over the direction their fund takes and evaluate its performance (Dawkins 1992, p. 13). Importantly, it is the quality of financial information disclosures that is fundamental to effective decision-making.

The Australian accounting conceptual framework identifies 'relevance' and 'reliability' as the two primary qualitative characteristics that financial information must possess to be useful for economic decision-making (AARF 1990, para. 7). Information is considered relevant if it enables decision makers to evaluate past outcomes and form predictions; it should also assist with assessing the rendering of accountability by preparers (AARF 1990, para. 8). To be reliable, financial information needs to faithfully represent, without bias or undue error, the underlying transactions and events that have occurred (AARF 1990, para 16). To be relevant and reliable, information selected for disclosure needs to be comparable and understandable (AARF 1990, paras. 31-38). A constraint on the relevance of information is timeliness in that information loses relevance if its disclosure is unduly delayed (AARF 1990, para. 39).<sup>15</sup>

Based on these qualitative characteristics, it is evident that current financial information disclosures by superannuation funds are inadequate for members' choice decision making. In particular, an absence of standardised performance measures renders the rates of return and other performance ratios reported by funds as unreliable and not comparable. Moreover, access to relevant information on fund performance is subject to

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<sup>14</sup> Even this mechanism has limitations as superannuation fund members have little or no power to remove non-performing trustees, and in a limited choice environment, costs and restrictions imposed on investment choice may deter fund switching despite poor performance.

<sup>15</sup> These qualitative characteristics are consistent with Breyer's (1982) view that disclosure is likely to be effective only where the users can understand the information disclosed, where users are free to make choices on the basis of that information, where users believe the information is materially relevant to their choices, and where it has been transmitted to users in a simple and meaningful way.



delays and is largely confined to the member's own fund due to limited availability of information about other funds (Gallery 1994; Gallery et al. 1996).

Standardisation of measuring fund performance information arose as a critical issue early in the choice debate. It has been suggested that the presentation of investment returns and fees and charges should be heavily standardised to enable comparisons between funds (SSCS 1998, para. 6.14). However, the (then) Insurance and Superannuation Commission (ISC) indicated reluctance to mandate standardised measures of performance through regulation. While the ISC (1997) strongly supported the voluntary performance reporting standards developed by the Australian Investment Management Association (AIMA) for wholesale investment managers,<sup>16</sup> it did not propose to incorporate such standards into regulation. Rather,

... the ISC considers it preferable to rely on market pressures rather than legislative intervention to maximise compliance with such standards. ... [M]aking the standards mandatory, through regulations, could introduce an unwarranted degree of inflexibility into the ongoing development and application of the standards. (ISC 1997, para. 62)

This 'leave it to the market' approach means that existing variations in the way that investment return information is measured and disclosed in superannuation fund reports will continue to lack comparability. Added to this problem are concerns about a lack of uniformity in disclosures of management fee information. Guidelines for calculating the management expense ratio (MER) to facilitate comparisons of fees have been developed by the superannuation industry. However, because MERs can be calculated differently and can include or exclude a wide range of fees, MERs are not comparable among different funds (Mace, 1998).<sup>17</sup> Consequently, in the absence of standardised measures of fund investment returns and fees, members are presented with information about alternative funds that has been derived in a variety of ways. These inadequacies in disclosure of financial information highlight the significant information asymmetries evident in the current system which, in turn, impose severe limitations on informed choice.<sup>18</sup>

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<sup>16</sup> The Investment and Financial Services Association (IFSA) has similarly developed investment return reporting standards for retail funds.

<sup>17</sup> One commentator suggests that given the doubts that professionals have about MERs, they are of little use to the average fund member, likening them to "studying trigonometry tables" (McIlwraith, 1998, p.24).

<sup>18</sup> Disclosure by superannuation funds has also been subject to more general criticism. For example, in his comments about the prospect of administration fees rising as a proportion of investment returns, Kohler (2001, p.23) states that because

### 5.3 Regulatory failure

Ideally, regulations should address market failures such as problems of information asymmetry but regulation may fail if it is poorly designed and implemented leading to costs that exceed benefits. In a choice environment, regulatory failure represents a constraint on members' ability to make genuine choices. The current system attempts to protect members but fails to do so because it is reliant on members actively participating in the system. Because there is no opportunity for members to opt out of the decision making process, the regulatory system fails to take account of the endogenous constraints on members' choice. In particular, it fails to recognise that many members do not have the necessary skills or willingness to monitor and keep track of their superannuation savings. As a consequence, the regulations have failed to protect the superannuation benefits of large numbers of workers who are particularly vulnerable. The specific problems that regulation is not adequately addressing are lost members, small accounts balances and the SG voucher system.

The combination of the lost members and small account balance problems has led to an undesirable situation where there are increasingly large numbers of unconsolidated accounts with a substantial cumulative total of funds which is generally poorly invested. The ATO is concerned about the "ballooning" number of lost members (SSCSFS 2001a, para. 5.17), but it appears that little is being done by the ATO, State Governments or the industry to reunite members with their lost superannuation savings (SSCSFS 2001a).<sup>19</sup>

In a review of the Superannuation Guarantee, the Auditor-General identified a number of concerns including a lack of a prosecution strategy for SG avoidance, a high number of unredeemed vouchers and the need for developing better coordination mechanisms (ANAO 2000). This finding points to the failure of the educative process to alert superannuation fund members to their entitlements. Employees do not earn interest on funds associated with SG vouchers until they are redeemed, and lapse if not redeemed within 10 years (SSCSFS 2001a). Added to this problem is the issue of employers' failure or unwillingness to set aside funds to contribute to employee superannuation as part of the requirements of the SG. It is argued that the systemic effects of complexity and long chains of implementation, together with employer recalcitrance and ineptitude combine to subvert the original intention of a better retirement income for many workers. The Auditor-General's review warned that the

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disclosure standards in the superannuation industry are "so woeful ... only the most attentive and sophisticated fund members will know what is happening".

<sup>19</sup> The growth in lost members is exacerbated by employers inappropriately using the SHAR as a default fund to avoid administrative costs associated with collecting employee information and finding a suitable fund (SSCSFS 2001a).

failures of the SG system threatened the government's intention to 'reduce reliance on the age pension as a means of funding retirement for individuals' (ANAO 2000, p.15).

## **6. MEMBERS' CHOICE PREFERENCES – ACTIVE AND PASSIVE**

Simply introducing choice without addressing the endogenous and exogenous constraints is likely to exacerbate existing problems and result in further undesirable outcomes for both fund members and the superannuation system. While choice is widely regarded as desirable, the system needs to cater to both those individuals who want to exercise choice and those who prefer to opt out of an active decision making process. Accordingly, a 'true choice' model should recognise the diversity of fund members' choice preferences. That is, some fund members want to actively participate in the management of their superannuation savings and so prefer to exercise 'active choice'. On the other hand, others prefer not to actively participate, choosing instead to allow third parties to manage and monitor their superannuation entitlements. This choice, whether implicit or explicit, represents 'passive choice'. It is important to recognise that a passive choice does not imply that those members do not want choice. Members are likely to want an option to exercise active choice in the future and the value of the option could increase as the endogenous and/or exogenous constraints diminish (e.g. as the amount of the superannuation investment increases, member's financial expertise increases or members approach retirement).

The choice model would then encompass a two-pronged approach to superannuation fund management and policy which provides opportunity for both active choice and passive choice. Accordingly, policy resolutions need to be cognizant of both of these choice preferences.<sup>20</sup>

## **7. POLICY RESOLUTIONS**

Providing members with choice of fund is an important step in ensuring that the superannuation industry operates efficiently and members exercise greater control over their superannuation savings. In relation to the active choice option, the key constraints on informed choice are inadequate disclosure standards and financial expertise. To overcome these constraints, we argue that disclosure standards need to be improved prior to

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<sup>20</sup> A broader view of choice gives consideration to allowing low-paid workers to choose to opt out of the superannuation system by receiving immediate wage payments instead of superannuation benefits in the future (Davidson 1995, ACOSS 1996). Whilst this view has merit, there are a range of eligibility factors that need to be analysed, such as income threshold and interactions with the taxation and social security systems. This aspect of superannuation choice is beyond the scope of this paper and represents an area for future research.

implementation of an appropriate education program. Regarding the passive choice option, we suggest that the establishment of a universal default fund will effectively overcome many of the problems associated with member disengagement.

### **7.1 Disclosure standards**

During the debate over the proposed choice legislation, the Labor Party flagged the need for the development of an accounting standard as part of the choice regime to enable proper comparisons of fees and charges between funds (Davis 2000). The ACTU has similarly called for standardised disclosure of financial information by superannuation funds (*Superfunds*, June 2000 p.9). Submissions and evidence given to the SSCSFS roundtable on choice of superannuation funds emphasised that a standardised disclosure regime is an essential pre-condition for informed choice (SSCSFS 2000). The Institute of Actuaries of Australia suggest that as a minimum, there needs to be standardised disclosure of fees, charges and investment returns and a common reporting date, without which “it will not be possible for consumers to assess the comparative performance of different funds, and effectively measure and evaluate effects of costs measures against returns” (SSCSFS 2000, para 4.10). As discussed earlier, much work has already been done by the industry in developing standards for reporting investment returns and management expense ratios and this could provide the basis for establishing legislated standards.

Standardised measures of expenses and returns would logically be included in existing financial reporting regulation governing disclosures by superannuation funds. As such, the accounting standard AAS 25 “Financial Reporting by Superannuation Plans” could incorporate standardised performance measures that superannuation funds have to disclose in their audited accounts. Consistent with uniform disclosure of performance measures by companies (e.g. as required by AASB 1027 “Earnings per Share”), similar standardised performance disclosures could be established for the superannuation industry. Indeed, the overall benefit is likely to significantly exceed the additional reporting costs.

AAS 25 is currently under review<sup>21</sup> and, in anticipation of this review, the SSCSFS (2001b, para. 6.33) expressed an expectation that standardisation issues, such as the definition of ‘administration expenses’, would be addressed by the review. Unfortunately, the exposure draft of the proposed revised standard does not include any reference to how standardised expense ratios or investment returns should be measured. Thus there appears to

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<sup>21</sup> In July 2001 the Australian Accounting Standards Board issued an exposure draft of a revised version of AAS 25.

be little progress towards ensuring that key information about fund performance is standardised so that members have comparable information on which they can rely to make informed choices. Unless standardised measurement of performance ratios are established, within-fund and between-fund comparisons are unreliable and consequently informed choice is severely restricted.<sup>22</sup>

## **7.2 Member education program**

Historically, an education program has been the vehicle for ensuring that citizens comprehend the system of superannuation. In 1989 the Labor government stated that an education program would be implemented to ensure the community understood the benefits of superannuation savings (Howe 1989). Since that time governments have assumed unproblematically that better education would lead to better understanding and engagement with the superannuation system. However, it is argued that with each iteration of the changes to the superannuation system, either through greater regulation or offering different choices, has required more active decision-making and subsequently created higher risks to accumulating or maintaining members benefits.

The nature and scope of appropriate member education is contingent on the capacity and willingness of members to exercise choice. As discussed previously, a genuine choice model would cater to the needs of those members who want to actively participate in market-based decisions and those members who prefer to opt out of the choice decision because they do not have the proficiency and/or are unwilling to make the decisions. Attempting to force superannuation education on *all* members irrespective of their choice preferences would clearly be unproductive in relation to substantial numbers of members. Therefore, an appropriate education program needs to be targeted to those who are prepared to *actively* engage in decisions regarding the management of their superannuation savings. Such a program needs to be ongoing and delivered by parties independent of any vested industry interests.

## **7.3 Universal default fund (UDF)**

Proposals for a government-run National Superannuation Fund have been raised at various times but have never been brought to fruition (Paatsch and Smith 1992). Although there are indications that substantial numbers of people would prefer the government to

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<sup>22</sup> In the absence of choice decisions, disclosure of standardised performance information is still necessary to enable members to make valid within-fund and between-funds comparisons, given that disclosure represents a key prudential control in the Australian superannuation system.

manage their superannuation rather than private sector funds,<sup>23</sup> neither the present Coalition Government nor the former Labor Government have canvassed government-managed superannuation as a possibility. The management of the superannuation system has always been the province of the private sector (Gallery et al. 1996). Given that government has been prepared to mandate superannuation savings, it is incumbent on the government to provide a ‘safety net’ for those compulsory savings to address the constraints and risks associated with a fully privatised pension system. Establishing a universal default fund for superannuation members if members are unable or are unwilling to exercise choice may alleviate such risks. In this case, there is a responsibility on government to facilitate passive choice by providing a fund that that is secure and preserves superannuation entitlements throughout working careers.

Under the Government’s proposed choice of fund legislation, superannuation contributions would have been directed to a default fund if members did not nominate a fund. The SSCS (1998, para. 8.24) highlighted the importance of ensuring “that default funds protect the interests of employees who are unable to protect their own long-term interests”. Given the likelihood of “significant numbers” of members not choosing a fund,<sup>24</sup> “there is a strong case for setting minimum standards for default funds” (SSCSFS 2000, para. 6.1). However, the Investments and Financial Services Association argued that such standards would work against underlying competitive pressures (SSCS 1998). This suggests that the objectives of protecting members’ interests and market competition are irreconcilable. A viable alternative is to establish a universal default fund (UDF) to cater for those members who are unable or are unwilling to make informed choices. This is justifiable for two reasons. First, given that workers are forced to save for their retirement through superannuation, the government has an obligation to protect the savings of vulnerable members who are incapable or are unwilling to manage those savings themselves. Second, as the fundamental purpose of mandatory superannuation savings is to reduce future dependence on the age pension (SSCS 1998), it is in both the government’s and taxpayers’ interests to ensure that those savings are not frittered away due to poor fund choices.

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<sup>23</sup> For example, a 1998 survey of 2,400 householders found that 23% of all respondents, and 29% of respondents with an annual household income of \$40,000 or less, prefer a government-managed superannuation fund (Valenzuela & Webster, 1998).

<sup>24</sup> Based on experiences of within-fund investment choice and other surveys of consumer attitudes to superannuation, the Association of Superannuation Funds of Australia suggests that as many as 50 to 70 percent of consumers will not want to make an active choice (SSCSFS 2000, para. 6.4).

In addition to the provision of an increased level of security, the introduction of a UDF would resolve or alleviate many of the serious problems inherent in the current system. First, being broadly based, the UDF could serve as a repository and accumulation fund for members' funds that cannot be managed economically by existing private-sector funds. The UDF would consolidate multiple small account balances and allow members to more effectively monitor investment performance. This would obviate the need for the involvement of the ATO for the management of these funds as a temporary custodian and alleviate the problems of member protection and lost members. In effect, consolidation of accounts would reduce administrative costs and remove cross-subsidies within existing funds.

Second, with the UDF's potentially large pool of funds there is a possibility of providing benefits and services to members that are currently available to members in some of the larger industry funds. Such benefits may include low-cost death and disability insurance and lower-cost financing. Third, the UDF could provide a benchmark for measuring the performance and accountability of all other funds. The UDF would be expected to provide model operating and disclosure standards which would allow close public scrutiny of performance and regulatory compliance. As a consequence, considerable pressure would be placed on all other funds to be more competitive, ultimately benefiting all superannuation fund participants. Importantly, a government-regulated universal default fund will assist in fulfilling the government's obligation to ensure that compulsory retirement savings are secure, accessible and equitable.

In combination, a standardised disclosure regime, appropriate member education and the option of a government-run default fund are more likely to lead to an environment where 'informed choice' is achievable, relative to the haphazard and much criticised approach presently advocated by the Federal Government.

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