



COVER SHEET

This is the author-version of article published as:

Gallery, Natalie (2002) Superannuation fund choice: Opening Pandora's Box .
Australian Review of Public Affairs (Digest)(5 September 2002).

Accessed from <http://eprints.qut.edu.au>

Copyright 2002 University of Sydney

Superannuation fund choice: opening Pandora's Box

Natalie Gallery
University of Sydney

Earlier this year the Federal Government resurrected its policy on choice of superannuation fund after its bill on this issue failed in the Senate in 2001. Presently most employees have to join the superannuation fund specified by their employer or workplace agreement. Choice of fund means that employees will be able to choose which fund they join and have the freedom to subsequently switch to another fund. The Government expects that greater freedom of choice will increase competition between funds, which in turn will reduce fund costs, increase returns and consequently maximise members' benefits (SSCS, 1998). Informed choice is essential for the choice of fund objectives to be met but significant barriers to informed choice presently exist. These barriers include an absence of relevant information disclosures by superannuation funds and the greater problem of members who are unable or are unwilling to exercise choice. While the first barrier could be overcome by establishing standardised measures of fund performance, the potential problem of large numbers of workers not exercising choice requires rethinking the default option. A possible solution is the establishment of a universal default fund.

Barriers to Achieving Informed Choice

The Government first flagged its intention to introduce choice of fund during the 1996 election campaign. After several iterations between the House of Representatives and the Senate, the bill ultimately failed on the vote of the Democrats who supported the choice bill but sought to trade off their support on that bill in exchange for the Government addressing another unrelated superannuation matter (same-sex couple rights to access of superannuation benefits). The Government declined the Democrats 'deal' and the choice issue was shelved.

After vigorously opposing the Government's choice of fund proposals for many years, the Labor Party is also now canvassing the choice issue in a policy options paper (see Sherry, 2002). Now that choice of fund is firmly back on the agenda, no doubt those same issues

which arose during the six-year battle over the choice bill will be redebated. Although there was universal agreement that informed choice is an essential prerequisite for a choice-of-fund system to work effectively, the question of how informed choice might be achieved was not fully explored. Disclosure and education were flagged as two key factors impacting informed choice. To exercise informed choice, superannuation fund members first need access to relevant and reliable information, and second, fund members need to have the capacity and motivation to use that information.

Effective disclosure is controlled by superannuation funds and through regulation. The capacity and motivation issue is internal to each individual member and this can be influenced by factors such as education programs. The problems with both fund disclosure practices and members' capacity and willingness to exercise choice need to be addressed before choice is widely introduced. The dangers of not doing so could see Australia experiencing the same sorts of problems as in the U.K. where billions of Pounds of retirement savings were lost through mis-selling when choice was introduced. In 1988 legislation came into effect in the U.K. giving employees greater choice by allowing them to transfer from their employer-sponsored pension plans to a personal pension product offered by insurance companies (Select Committee on Treasury, 1998). Large numbers of employees were lured away from sound company pension plans by unrealistic promises made by insurance companies and independent financial advisers, resulting in them suffering "considerable financial detriment" (SSCS, 1998, para. 11.4). By the early 1990s this mis-selling became clear and regulators stepped in stop the practices and seek compensation for the losses suffered. A recent estimate of the total amount that insurance companies are likely to pay out in compensation is \$A27 billion (McIlwrath, 2000). The vast majority of those affected were individuals with reasonable levels of education and in many cases were highly trained professionals (e.g. academics and teachers), showing that even well-educated individuals are susceptible to making poor pension plan choices (Kennedy, 1998).

While active choice involves risks associated with making wrong decisions, there is a potentially larger problem associated with members who are unable or are unwilling to exercise choice. Under a choice-of-fund regime the employer of those individuals will direct the members' contributions to a default fund, which under present proposals is likely to be the major fund in operation in the individual's workplace. The Senate Select Committee on Superannuation (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"

and the need for greater regulation of default funds. However, industry representatives argued against increasing regulation of default funds because it would work against underlying competitive pressures (SSCS, 1998, para. 8.16). This apparent conflict between the two objectives of protecting the interests of members in default funds and market competition requires rethinking the default fund option.

Disclosure of comparable and understandable information

While superannuation disclosures have recently been expanded under the Financial Services Reform (FSR) Act, there is a question of whether the reforms have delivered on their specific aims, that is, to provide comparable and understandable information. The Australian accounting conceptual framework includes these two characteristics of comparability and understandability as essential for financial information to be useful for decision making, however, the characteristics of ‘relevance’ and ‘reliability’ are pre-eminent (SAC 3). That is, for information to be useful it needs to be relevant to the decision at hand, and is reliable if it faithfully represents, without undue bias or error, the substance of the transactions and events that the information purports to represent.

Two key aspects of superannuation funds’ operations which are relevant to members’ or potential members’ decisions are the income generated and fees charged by the fund, usually measured as investment returns and management expense ratios (MERs) respectively. Standardisation of such performance ratios ensures reliability and comparability, in that if all superannuation funds use the same bases to calculate the ratios, then there is greater confidence that the rates of return and MERs of different funds represent the same types of underlying economic events, and are therefore comparable. Present industry guidelines on calculation of MERs and other performance ratios are unreliable, even on the admission of industry insiders, because there is scope to include or exclude various items. Prescribing how the ratios are measured in an accounting standard will enhance the reliability of such information.

During the previous debate on choice of fund, concerns were expressed about the lack of consistency in application of industry guidelines on performance measurement and the absence of enforceable standards. When the (then) Senate Select Committee on Superannuation and Financial Services learned from the Chairman of the Australian Accounting Standards Board in early 2001 that the accounting standard governing the preparation of superannuation fund financial reports (AAS 25) was to be reviewed, they

expressed hope that revisions to the standard would address the standardisation issue (SSCSFS, 2001). However, the draft of the revised accounting standard (ED AAS 25) that was issued by the Institute of Chartered Accountants in mid-2001 does not address the issue of standardising the method of calculating performance ratios. To date no further discussion or proposals on revision of the accounting standard have been issued by either the accounting profession or the accounting standard setters. It seems that a valuable opportunity to establish standards to ensure superannuation funds disclose information which is comparable has been lost.

In relation to the second aim of the FSR reforms – for disclosed information to be understandable – two issues arise. First, to make financial information more understandable generally requires simplification of that information (e.g., graphical presentation). However, with simplification information is lost, giving rise to a paradox: if financial information is simplified to make it more understandable, then the loss of detail makes the information less reliable. Such transformations are also open to manipulation (in the absence of audit). Given that superannuation information is by nature complex, simplification inevitably leads to disclosure of less reliable, and therefore less useful information.

Capacity and motivation of members to exercise choice

Even if the problems with ensuring disclosure of reliable, comparable and understandable information were overcome, there is still the issue of whether superannuation fund members have the capacity and/or motivation to use the information to exercise choice. With the introduction of choice the Government proposes to include an education program for the eight million or so superannuation fund members. However, many simply do not have the capacity to become adequately informed to make informed choices. ABS statistics show that 46 percent of Australians have “unsatisfactorily low levels of literacy” and 15 percent are “functionally illiterate” (SSCSFS, 2000). These statistics suggest that educating the vast population of superannuation members to adequate levels of financial literacy for them to make informed decisions about their superannuation is problematic.

A further issue is that of members suffering ‘emotional disengagement’ from their superannuation. Structural changes in the labour market have exacerbated the problem with the growth of casual jobs increasing the risk of workers losing track of their superannuation entitlements, as evidenced by some recent surveys. One survey found that up to 50% of workers are unsure to which fund their superannuation contributions have been directed

(Lampe, 2001). Another survey similarly found that 64 percent of fund members had little or no knowledge of their funds, 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).

Widespread member disengagement is further evidenced by the large amounts of money the Australian Taxation Office (ATO) has collected from employers who failed to comply with SG obligations (\$100 million represented by 403,000 unredeemed SG vouchers) for which the ATO is trying to find the owners (ANAO, 2000). Then there are the lost members, that is, those members with whom superannuation funds have lost contact and have been referred to the ATO Lost Members Register. There are approximately 4 million accounts with total assets of \$5.5 billion on the register, representing about 18 percent of total superannuation accounts (Productivity Commission, 2001). If large numbers of members presently do not have the ability and/or motivation to keep track of their superannuation entitlements, are they likely to actively exercise choice when it is offered?

Most people agree with the principle of fund choice as shown by the ASSIRT Investor Market Trends survey which found that 83 percent of respondents considered choice-of-fund legislation to be a 'good' or 'great' idea (Superfunds, 2000). However, when choice is actually offered, as is the case where many funds offer their members investment choice, on average, fewer than ten percent of members actively exercise that choice (SSCSFS, 2000). This suggests that many individuals value choice as an option, but are willing to exercise that choice only where the expected benefits exceed risk transfer costs (Brown, Gallery & Gallery, 2002). That is, becoming informed is costly, particularly in relation to complex superannuation issues. Such costs include the time taken to acquire, read and interpret relevant fund reports and other material, attend training session, and to seek professional advice from financial experts or other information intermediaries. There is also the risk and associated costs of making the wrong decision. If these costs exceed the perceived benefits of choice, then members will rationally avoid the choice decision. Even where members have the capacity to become informed to exercise choice, risk transfer costs are likely explain why they do not do so (Brown, Gallery, Gallery & Guest, 2001).

The way forward?

With the recent corporate collapses and accounting scandals, much has been said about the need for greater transparency and improved disclosure by corporations. Although there have

also been concerns expressed about super fund disclosure by various reviews including those undertaken by the Senate Select Committee and the Superannuation Working Group, there has not been a concerted effort to remedy the inadequacies of the disclosure standards and practices. The disclosure problem can be relatively easily overcome by putting in place a set of effective disclosure rules which ensure that trustees are fully accountable to their members, and members and others have full access to relevant, reliable and comparable information about the financial position and performance of superannuation funds.

However, establishing and enforcing disclosure standards does not overcome the wider problem of members lacking the skills or motivation to become informed to exercise choice. If choice is introduced in the current environment where there are large numbers of individuals who are unable or are unwilling to exercise choice, there is a very real danger of exploitation on a massive scale such as that experienced in the U.K. Past experience of low take-up rates where choice is offered suggests that when choice of fund is introduced universally, only a minority of members will actively participate in the choice decision. The Association of Superannuation Funds of Australia estimates that as many as 50 to 70 percent of workers will not make an active choice of fund (SSCSFS, 2000) and therefore will end up in the default option. If this is the case then the standards and benefit protection mechanisms in default funds becomes paramount. Given arguments that increased regulation of default funds will work against competition in the superannuation industry, a viable alternative is to establish a universal default fund (UDF), as suggested by Brown et al. (2002). It would be more efficient to more closely regulate a single UDF than multiple default funds, and the UDF would still be subject to competitive market pressures (i.e., members of the UDF would still have a choice to join another fund. Thus a government-regulated UDF would cater for those members who are unable or unwilling to make informed choices and ensure their retirement savings are not frittered away by poor fund choices or exploitation. While such a move is likely to be unpalatable to both major political parties and the superannuation industry, it nevertheless presents a possible solution to a widespread problem. In an industry worth over \$500 billion there is huge potential for vast sums of retirement moneys to be misallocated or lost. There is clearly a need to address existing problems in the superannuation system before the Pandora's Box of choice-of-fund is opened.

References

- Australian National Audit Office. 2000, *Superannuation Guarantee, Australian Taxation Office*, Audit Report No 16 1999-2000, Performance Audit, Canberra.
- Brown, K., Gallery, G. and Gallery, N. 2002, 'Informed superannuation choice: constraints and policy resolutions', *Economic Analysis & Policy* 32 (1), pp.71-90.
- Brown, K., Gallery, G., Gallery, N. and Guest, R. 2001, 'Defined Benefit or Accumulation Plan? Superannuation Choices of Australian Academics', paper presented at the *Ninth Annual Colloquium of Superannuation Researchers*, University of New South Wales, 9-10 July.
- Kavanagh, J. 'Start Delay Won't Spoil Super Choice', *The Weekend Australian*, 11-12 April 1998, p.3.
- Kennedy, R. 1998, "Focus will be on understanding choice", *Superfunds*, April, p.13.
- Lampe, A. 'Super a Mystery for Most Workers', *The Sydney Morning Herald*, 16 May 2001, p.3.
- McIlwraith, J. 2000, "UK pension nightmare a lesson for us", *Superfunds*, April, 54-56.
- Productivity Commission. 2001, *Superannuation Industry (Supervision) Act 1993 and Certain Other Superannuation Legislation*, Report No. 18, Ausinfo, Canberra.
- Select Committee on Treasury. 1998, Ninth Report, House of Commons, United Kingdom.
- Senate Select Committee on Superannuation. 1998, *Choice of Fund*, 28th Report, Parliament of the Commonwealth of Australia, Canberra, March.
- Senate Select Committee on Superannuation and Financial Services. 2000, *Roundtable on Choice of Superannuation Funds*, Commonwealth of Australia, Canberra, March.
- Senate Select Committee on Superannuation and Financial Services. 2001, *Prudential Supervision and Consumer Protection for Superannuation, Banking and Financial Services*, First Report, Commonwealth of Australia, Canberra, August.
- Sherry, N. 2002, Superannuation Policy Paper A: 'Broader Choice, Stronger Protection and Fairer Tax', August.
- Statement of Accounting Concepts SAC 3 'Qualitative Characteristics of Financial Information'.
- Superfunds*, 'Investors endorse choice of fund', June 2000, p.5.

Dr Natalie Gallery is Senior Lecturer in Accounting at the University of Sydney.

Email: n.gallery@econ.usyd.edu.au