

Buttoning Up Superannuation¹

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Introduction

The Australian auto industry of 25 years ago bears many similarities to today's superannuation industry. Notwithstanding the many dissimilarities, such as the former's substantial fixed costs and the near impossibility of determining quality in the latter, *some* of the ways and means that were used then to 'fix' the auto industry can be adapted to 'fixing' the super industry now.

Cars c.1986

For over a decade John Button was the reformist Minister for Industry and Commerce in the 1983 first Hawke Cabinet. Unlike today's pusillanimous populist governments this was one of energy, courage and conviction, attributes with which Button was over-endowed. He was responsible for the eponymous plan to make the Australian car manufacturing industry efficient and competitive and to provide better quality and more affordable cars, (Automotive Industry Authority 1989). This was to be achieved through a blend of open markets and government direction, (Bracks 2008) that *inter alia* would result in an exporting component industry. From 1968 to 1985 the auto industry had been cosseted by a 57.5% tariff, import quotas, local content plans, and export facilitation that led to complacency, inefficiency and overcapacity, (Sanidas & Jayanthakumaran 2003).

As Button recalled, "... the industry seemed almost ridiculous. It had five manufacturers producing thirteen different models. There were manufacturing plants scattered in five states ... By world standards the manufacturers had small production runs ... Exports were minimal ... (however) in this web of mediocrity there were some well motivated people trying to break out." (Button 1999). His plan "amounted to reducing the very high tariffs, rationalizing manufacturing plants and the component sector, more exports, better industrial relations and improvements in the production processes and in quality ... Inevitably this would mean plant closures and fewer employees. It would mean consolidation of the industry ... ", (Button 1999). He placed special emphasis on improving the skills of both workers and management through re-training because the skills and knowledge of 20 years earlier were no longer adequate.

The Plan's aims were to be achieved through "improving economies of scale by cutting the number of models from 13 to 6 or less" within eight years, (Information Kit 1984). The Automotive Industry Authority was established to implement the plan and to monitor the progress of re-structuring, (Automotive Industry Authority 1986)

Was the Plan a success? Broadly, yes. As the Industry Commission put it in 1997, "the industry developed in ways which could not have been foreseen at the start of the assistance reduction program." A 2008 review concluded that removing quotas and lowering protection led to some industry rationalization, made imports

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more accessible, and made the industry more internationally competitive and export-focused, (Bracks *op cit*). Indeed, the industry became one of Australia's top ten export earners and the largest manufacturing export earner at 10.7% of manufacturing exports in 2007. In 1991 10% of local product of Australian motor vehicles was exported. By 2007 this had increased to 42%.

These advances have not been sufficient to keep up with the incredible growth in the developing world's automotive manufacturing and R&D⁴ whose effect has been a decrease in sales of Australian manufactured vehicles and in the proportion of domestically manufactured components⁵, with a number of component suppliers going broke while others became more efficient through pressure from manufacturers and suppliers. Perhaps at best the Button Plan kept the Australian automotive industry alive longer than it would have without intervention, but in the long run advances in manufacturing efficiency and product quality in the developing world, excess capacity and the relative strength of the \$A make it increasingly difficult for the industry to thrive.

Superannuation c. 2011

Overcapacity and costly excessive choice are the dominant similarities between *Cars Then* and *Super Now*.

As at June 2010 there were 442 APRA-regulated super funds, of which 218 had more than \$50m in FUM and 77 had more than \$500m, (APRA(a) 2010). Two sources of justification provide a cloak of legitimacy for this number of funds. First, is a semi-religious belief in markets, in the supposed *intrinsic* benefits of freedom of choice and in the supposed *intrinsic* efficiency of competition. Second, is a human desire to seek comfort and security in small affinity groups with common interests, backgrounds or activities. Yet, for almost all fund members those justifications impose burdens on their retirement incomes that are both *costly* and *irrelevant*.

As the Nobel Prize winner Herbert Simon showed 50 years ago, (Simon 1978), (Schwartz 2005), excessive choice "consumes attention", making it a potentially dangerous distraction to effective decision-making. It is neither universally desirable nor a free good. On the first point, (Henrich *et al* 2010) show that demand for choice is culturally determined and not universal. For instance, one study of obvious relevance to superannuation, found that "European-American children preferred working on a task, worked on it longer, and performed better on it if they had made some *superficial* (emphasis added) choices regarding the task than if others made the same choices for them. In contrast, Asian-American children were equally motivated by a task if a trusted other made the same choices for them." On the second point, since competition between funds was imposed through choice of fund nearly five years ago, *all* funds' costs have risen to accommodate choice while a miniscule 1.5% of members have voluntarily exercised that choice, (Fear & Page 2009). Excessive choice is further reflected in members' average 2.9 individual accounts, because, being uninterested and disengaged, employees open new accounts when changing jobs. The Cooper Review's recommendations should provide a mechanism for the automatic consolidation of member accounts, thereby reducing the administration fees and insurance charges that can consume small accounts, (Cooper 2010). However, resistance to consolidation of accounts has begun as funds perceive the threat to their large number of profitable inactive accounts.

As has been argued elsewhere, (Bird & Gray 2009), competition in superannuation and especially competing on investment performance tends to *lower* overall market returns and hence imposes a direct cost on members net of any benefits. A decade ago Sweden created six pension funds in the belief that members would benefit from competition. Unsurprisingly, career risk ruled, funds herded, converged on very similar strategies and didn't compete. A proposal before the Swedish government is for a single national fund, as the Whitlam government proposed for Australia some 35 years ago, (Björkmo 2009).

⁴ From 1999 to 2008 global light vehicle production grew by 32%, (OICA 2008). Throughout this period capacity has exceeded demand and is expected to do so in the future, (IHS 2011).

⁵ From 2002 to 2008, GM's sales fell 33%, Ford's by 10% and Mitsubishi's by 53%. Toyota was the only manufacturer to buck this trend, increasing sales by 22%, (Bracks *op cit*).

In pursuing the supposed benefits of competition further costs are incurred by extensive varieties of Member Investment Choices, choices that are rarely exercised. On the supply side, APRA-regulated funds over \$500m have an average of 11 investment options (some have 34). On the demand side, around 80% of fund members are invested in a Default Option, generally a 'balanced' strategy. That overcapacity is further magnified as only 25% of members actively chose that option, (Cooper 2010), (APRA 2011).⁶ Ever more choice, usually in the form of irrelevant cosmetic bells and whistles, is a consequence of the plethora of agents our system attracts as funds, managers and other agents try to differentiate themselves. As one instance, Australia has significant overcapacity and excessive choice in domestic listed equities. In a notoriously thin and lumpy market representing a mere 2% of global listed equity markets, Australia has over 80 active domestic equity managers.

The following APRA tables capture changes in industry capacity. Table 1 reveals quite strong fund consolidation over the past 14 years. Corporate and industry funds have consolidated at a greater rate than retail and public sector funds and show signs of continuing to lead consolidation. The number of funds shrank by an average 15% pa over that period, although in total and by each type the rate of consolidation has slowed considerably over the past four years. Moreover, there appears to be no evidence that the number and type of agents has shrunk in response.

Table 1. Number of Superannuation Funds by Type

	Jun-96	Jun-01	Jun-06	Jun-10
Corporate	4,100	3,224	555	168
Industry	169	150	81	65
Public Sector	93	81	44	39
Retail	372	265	174	154
ERF	13	10	18	16
Total	4,747	3,730	872	442

From an absurdly large number in 1996, over the next 5 years the industry only consolidated at less than 5% pa. Over the next 5 years the substantial 25% pa rate was driven largely by increased regulatory demands, especially by new regulatory licensing requirements, (Institute of Chartered Accountants/Deloitte 2008), (APRA 2007). In the four years to 2010 that rate fell to 16% pa, a rate that is likely to fall further. Resistance will increase and consolidation will slow as relief from capital gains tax for merging funds ends, and funds and their multifarious agents convince Government they have already achieved the optimal size necessary to act "in members' best interests." A recent case saw a proposed merger abandoned because the merged entity wanted trustees elected by the members while some existed trustees insisted on appointment by unions.⁷ But even were consolidation to continue at 16%, by 2020 Australia would have 85 superannuation funds, a figure that still smacks of overcapacity. By way of comparison, Australia has 56 banks, (APRA(b) 2010), a comparison that flatters superannuation as unlike superannuation funds many banks are highly specialised and some are inactive.

Tables 2 and 3 show that in spite of fund consolidation the average number of accounts per member has increased as balances have grown. Consolidation at the member account level remains elusive.

⁶ The one choice many people are exercising at a dramatic rate is Do-It-Yourself Super. Australia now has nearly half a million Self-Managed Superannuation Funds representing around 40% of all superannuation assets.

⁷ Australian Financial Review, Friday May 27, p1 report on Equisuper and Visionsuper.

Table 2. Average Account Balances (\$000)

	Jun-96	Jun-01	Jun-06	Jun-10
Corporate	35.2	57.8	86.5	90.8
Industry	3.9	8.0	15.1	19.6
Public Sector	16.2	42.3	52.4	55.2
Retail	9.8	19.0	28.8	31.5
ERF	1.2	1.0	1.1	0.9

Table 3. Average Number of Accounts/Member

	Jun-96	Jun-01	Jun-06	Jun-10
All types	2.0	2.5	2.9	2.9

Directly and indirectly members pay for overcapacity, yet the recent Cooper Review only suggested but did not explicitly recommend consolidation, although the Review probably has triggered further consolidation.

Strong support for the scale benefits of consolidation is apparent in Cost Effectiveness Measurement's data base, (Ambachtsheer 2009), in the Swedish report⁸, (Björkmo *op cit*), and in recent cries in Switzerland for a rationalization of pension funds.⁹ In a global world even \$30b may be 'sub-optimal', at least to minimise unit costs. A few years ago the CEO of the Ontario Municipal Employees Retirement Scheme, drew instant opprobrium from the industry by daring to suggest that his \$CAN50b was too small to maximise returns to scale. (Dyck & Pomorski 2010) argue that there is a 45-50 basis points difference in performance between a \$1b fund and a \$37b fund. They estimate the payoff to members is a 13% larger retirement benefit. More research is needed to determine just how and when *diseconomies* of scale arise and whether there are meaningful advantages to being small.

A major impediment to capacity reduction is the ever-spreading 'agent ecosystem' caused by the relative ease of transferring wealth from principal to agent, member disengagement, and increasing complexity. Trustees are an especially influential class of agents who often act as barriers to consolidation, efficiency and innovation. Even the CEO of the \$30b Australian Super fund has complained that some trustees act too much in their own interests by preserving their sinecure of board seats. The current Swedish model echoes this concern. Six funds each with an employee/employer board of 10 require 60 trustees. One of the authors (JG) was told *sotto voce* that in a country of only 9m it is "extremely difficult" to find 60 people (or 0.001% of the population) with appropriate talent, knowledge, skills, commitment, time and temperament. Australia with 22m and say 200 funds over \$50m needs around 1600 trustees¹⁰ with appropriate talent, knowledge, skills, commitment and temperament, or nine times per capita Sweden's need. A similar shortage of skill and talent is evident in the growing fashion to appoint ever larger in-house investment teams. For similar agency reasons limits on available skill and talent are also evident in many sporting competitions. For retail funds self-interest is reflected not in board seats but in executive roles, bonuses, related-party transactions and shareholder returns.

⁸ AP1-4 are 'buffer funds' for the national PAYG scheme; AP6 specialises in small cap Swedish stocks, and AP7 is an 'open architecture' fund.

⁹ http://www.ipe.com/news/switzerland-has-too-many-pension-funds-experts-say_40677.php.

¹⁰ This assumes 8 trustees per fund. The estimated total is lowered by the (unfortunate) policy of allowing trustee-directors to hold multiple board seats, compensated for by many funds having far more than 8 board members.

Autos Then vs Super Now

By comparing cars before Button to super now Table 4 highlights failures in retirement incomes policy due to sub-optimal industry structures and over-capacity.

Table 4. Cars Then ... Super Now

Issue	Cars Then	Super Now
Overcapacity	Yes. <ul style="list-style-type: none"> • 5 manufacturers • 13 models 	Yes. <ul style="list-style-type: none"> • Over 200 funds with more than \$50m FUM; Nearly 80 with more than \$500m • Over 2000 largely undifferentiated 'models' (aka, investment options) • Over 80 active Australian equity managers
High cost	Yes.	Varies. <ul style="list-style-type: none"> • Funds have yet to extract full cost benefits to scale • Rent-extraction among agents
Quality	Low.	Varies. <ul style="list-style-type: none"> • Structure generally comparable, and by some measures better, to world standards. (Mercer 2010) • The lump-sum policy is an evident weakness
Competitive	No.	Somewhat, but <ul style="list-style-type: none"> • Competing on returns <i>lowers</i> long-term returns • Most competition in financial services is cosmetic rather than substantive in terms of member benefits. • Minimal meaningful competition on price.
Co-operation	No.	Modest. <ul style="list-style-type: none"> • Some shared services and co-investments.
Vibrant	No. <ul style="list-style-type: none"> • Comfortable • Lacks innovation • Sinecure 	No. <ul style="list-style-type: none"> • Comfortable • Lacks innovation; driven by herding • Sinecure • Career and business risk rules, OK?
Exporting	No.	No. <ul style="list-style-type: none"> • Financial services account for 0.4% of exports compared to 10% for educational services. • 'Component suppliers' and Funds can export DC 'know-how'
Protected	Yes. <ul style="list-style-type: none"> • High tariffs • Concessions 	Yes. <ul style="list-style-type: none"> • Guaranteed contributions • Tax concessions • Default status
People	Once <i>were</i> appropriate. <ul style="list-style-type: none"> • Need higher level skills 	Once <i>were</i> appropriate. <ul style="list-style-type: none"> • Need higher level skills and temperament • Need to reduce direct and indirect agency frictions

Were John Button alive today as Minister for Superannuation he would surely declare, as he did a quarter of a century ago, that "... the industry seemed almost ridiculous. It had (over 200) manufacturers producing (around 2,000) (supposedly) different models. There were manufacturing plants scattered in five states... By world standards the manufacturers had small production runs ... Exports were minimal ... (however) in this web of mediocrity there were some well motivated people trying to break out." He would devise a plan that "amounted to reducing the very high (levels of protection), rationalizing manufacturing ..., more exports, ... and improvements in the production processes and in quality ... Inevitably this would mean (fund) closures and fewer employees (and trustees.) It would mean consolidation of the industry."

Button was sufficiently independent of thought to recognize both the power and the limitations of markets. Domestic competition had achieved little, so merely opening the industry up to international competition would likely achieve little more. Well ahead of his time he recognised that the auto industry needed a not-so-gentle *nudge* of paternalism to ensure effective consolidation, an approach valued even by Britain's Conservative prime minister, (Thaler & Sunstein 2008). To work effectively markets require well-informed buyers and sellers, but in superannuation and investments informational asymmetry will always be the 'natural state'. The confluence of superannuation's compulsory nature, its remote and abstract benefits, and its complexity ensures that the large bulk of members will forever be poorly informed. Financial *persuasion* might make a modest difference, (Schleifer & Mullainathan 2005), (Haslem 2011); financial literacy is unlikely to, (Ezra 2010). In fact it might even be counter-productive as the confluence of information overload and excessive choice will likely lead to poorer decisions and consequently lower returns, (Thaler, Tversky, Kahneman, & Schwartz 1997), (Benartzi & Thaler 2001), (Benartzi & Thaler 2002).

The opening volley of objections to *Buttoning Up Super* will surely be that 'industry policy' didn't work then and was shunted aside by free market fundamentalism. Button provided an instance of how it could and did work. More recently, the weaknesses and corruption of 'leaving it to the market' exposed by the financial crisis has renewed interest in improved approaches to industry policy. Even *The Economist* has offered it limited, guarded and critical support, (*The Economist* 2010).

Conclusion

To materially improve the retirement income of superannuation fund members, governments should develop a *Button Superannuation Plan* that goes far beyond Cooper's recommendations.

Somewhat mimicking the original Button plan it should aim to:

- Drastically reduce the number of funds, investment choices, and agents, including trustees and managers.
- Undertake independent research on economies and diseconomies of scale in order to make evidence-based decisions on the number and configurations of funds expected to 'optimise' benefits to members rather than to agents.¹¹
- Improve the quality, skills, selection, independence and monitoring of trustee directors and internal and external management. The Swedish proposal, (Björkmo *op cit*) recommends changing from industry body and union elected trustees to fully independent trustees.
- Impose strong governance standards on related-party transactions particularly for investments and insurance, multiple directorships, director appointments, and term limits.
- Encourage and reward more co-operation designed to improve members' net benefits. As one instance, replace *MySuper* with *OurSuper*, a relatively simple opt-out fund designed to pool risk and capture material benefits of scale, to be managed by the independent Superannuation Industry Authority (see below).
- Drive substantial increases in exports of financial services.

¹¹ One straw man structure, suggested by Ray King, is "7+7" consisting of 7 large mainstream funds that benefit from scale, and 7 smaller ones that drive innovation.

The Plan should contain milestones to be met through a combination of tax and other incentives, and through the threat of a potential lowering of concessions.

A truly independent *Superannuation Industry Authority* is needed to monitor implementation. Credibility demands the Authority be as independent as the RBA; sufficiently independent to elicit screams of pain from Sir Humphrey Appleby and from all agents. Independence is vital because in crude but realistic terms the Labor party appoints agents whose loyalty is at least split between their supporting unions and fund members; the Liberal party appoints agents whose loyalty is at least split between industry bodies and fund members. The current power of Parliamentary independents provides a rare opportunity to de-politicise retirement policies and to substantially reduce agency costs.

To hedge the risk of industry capture the Authority must be led and dominated by people not connected to the superannuation agency ecosystem. In particular, some members will be from countries such as Denmark, Netherlands, Sweden, with different systems. To provide the eternally disengaged member with a powerful voice and a meaningful negotiating position, some members of the Authority and some fund trustees should be appointed specifically to represent disengaged members, just as the legal system requires lawyers and mediators to represent those, such as young children, who cannot or choose not to represent themselves.¹²

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¹² The notion that those with no voice need specially designated representatives in negotiations and decision-making has its origins in a 1986 US proposal to give each parent half a vote per child, a proposal resurrected by Hungary's current governing party. A similar proposal has received some support in the context of the effects of global warming on future generations.

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