Institute of Actuaries of Australia

Reducing Retirement Income Costs

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Abstract

Australia's population is entering a period of great change as baby boomers move into their retirement years. As the inter-generational report, other actuaries and researchers have all pointed out, the proportion of the population reaching retirement is increasing rapidly. This effect is amplified by a maturing superannuation system via mandatory and voluntary contributions, so the expected cumulative monies available as a base for drawing retirement income will grow exponentially over the next 40 years.

Superannuation and pensioners' income have been a high importance, high priority constant on Government's policy agenda for many years. In the last year, the Cooper, Henry, Johnson and Ripoll reviews have all highlighted the sometimes complex but always very public issue of the perceived high cost in aggregate of Australia's current superannuation and retirement incomes framework as it currently operates.

As a starting point, it is reasonable to expect that retirement income costs are in relative terms higher than accumulation costs reflecting several interacting factors including lower volumes and a higher administration load from making payments rather than receiving contributions.

The industry is heading for a lot of pain, public dissatisfaction and critically the risk it is not serving all its members well, unless it pre-empts such higher costs by reducing likely future retirement income costs before they arise.

The paper examines:

- What these costs are?
- Where do they arise – investment, administration, service, risk reduction, advice?
- How the issues they reflect can be addressed?
- What is preventing the industry achieving substantially reduced costs particularly in retirement?
- How the costs might be reduced or minimised going forward?

In doing so it considers the perspective of a range of interested stakeholders but principally that of the members. There are flow on implications for providers, trustees, administrators, fund managers, regulators and government.

It concludes by highlighting specific suggestions for actions to meet the goal of lower retirement income costs.

Keywords: Superannuation, retirement income, costs, fees, operational efficiency, equity, financial planning, advice, investment, annuity, administration, guarantees

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1 Introduction and context

"When I was young I thought money was the most important thing in life, now that I'm old - I know it is!" - *Oscar Wilde*

1.1 Retirement goal

While Oscar Wilde's wisdom and wit was of a different era, his need would be no different today. Enabling a comfortable lifestyle after retirement means having sufficient retirement income to pay for that lifestyle, is the pending and actual retiree's most important goal. The achievement of that goal is significantly influenced by the costs incurred in the accumulation and retirement income / decumulation phases.

1.2 Aims of paper

The aims of the paper are:

1. To identify and explore the issues giving rise to costs that are specifically relevant to retirement incomes and to compare and contrast them with those costs relating to superannuation's accumulation phase.

2. To encourage and contribute to a debate on how future retirement income costs can be reduced or minimised by analysing these costs and related issues and making recommendations towards achieving the goal of reduced costs.

1.3 Data limitations, complexity analysis, opinions

Publicly available data on retirement income costs is very limited. Furthermore Australia's current retirement income product range is dominated by simple account based pensions. This cost base will change significantly as the alternative income stream products offering reduced risk and greater security, including income for life, are developed, distributed, supported by capital and administered. I acknowledge that costs are just one part of a complex and ever-changing mix of factors affecting the provision of retirement incomes. In these circumstances the extent of analysis I have been able to do is more limited than we would like but in the interests of debate and the reduction of retirement income costs in the medium to long term, I have formed opinions and reached conclusions and recommendations based on those opinions following the analysis.

1.4 Definitions

Retirement Income - the income after fees and other costs receivable by a pensioner from a superannuation provider.

This can include the income from a Self Managed Superannuation Fund (SMSF). Tax in the hands of the recipient is not considered, given that post age 60 such income is tax free under current government legislation. Retirement income which is external to the super fund, including Government pensions, and their related costs, are not included in the scope of this paper.

Costs – the total cost to a member in a superannuation fund across all elements contributing to the provision of retirement income from that fund.

These costs are often but not always explicitly identified as fees and charges. Where the context is superannuation costs in general rather that retirement income specific, the costs referred to are the equivalent costs for that group of members.

The underlying expenses in running superannuation's functional components drive the fees and charges the members are required to bear. Where providers at the superannuation fund or other service provider level are for profit, then a profit margin will be added to the bare costs to get to the ultimate costs, including fees charged, to members.

In this paper, tax has not been actively targeted as a cost for the purposes of reducing costs, but it is recognised as an important target for improving net after tax returns to members.

1.5 Key current issues affecting Retirement Income costs

The minimisation of costs relating to the provision of retirement income affects, and is affected by, a wide range of contemporary superannuation issues. At a big picture level, the major cost related industry issues, perceived and/or real, are:

Issues affecting accumulation and retirement income costs

1. Costs are too high
2. Lack of transparency around costs
3. Too many clipping the ticket too often at too high a price
4. Cost and value of provision of advice
5. Rise of the SMSF

Issues specifically affecting Retirement Income costs

While most issues affecting superannuation costs in general have a direct effect on retirement income costs, there are also several Retirement Income specific cost issues:

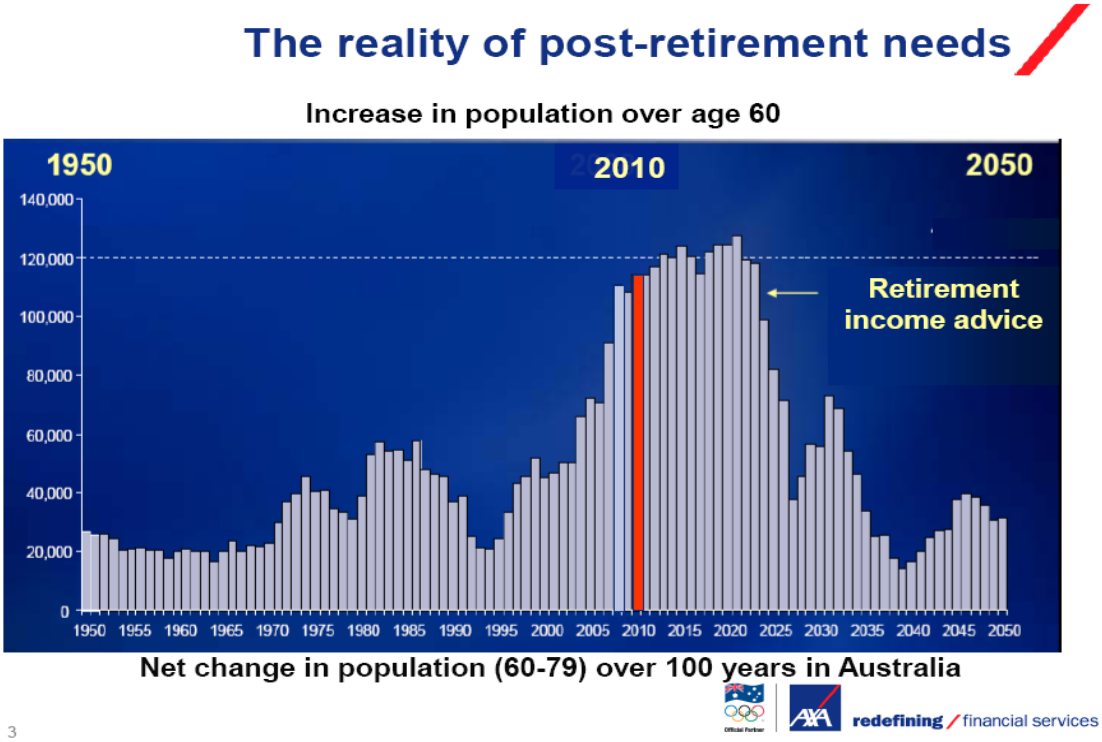
6. Retention of members before and during transition to retirement
7. Limited product and service range for retirement income
8. Lack of Government action to support greater diversity of retirement income products

The industry is heading for a lot of pain from public and government dissatisfaction and critically the risk it is not serving all its members well, unless it pre-empts the continuation of high costs by reducing likely high future retirement income costs before they affect much greater numbers of people.

1.6 Australian Superannuation – the Retirement scene - Context

1.6.1 Demographics

Australia's population is entering a period of great change as baby boomers move into their retirement years. The proportion of the population reaching retirement age is increasing rapidly and this will continue for the next 15 years. This is illustrated well by Jim DeCarlo of AXA[1] in Figure 1.1 where we see the numbers aged 60 to 79 over the past 60 and future 40 years.



Source Jim DeCarlo, AXA

Figure 1.1 Retirement Age Population Projection

1.6.2 Financials

This effect is amplified by a maturing superannuation system via mandatory and voluntary contributions, so the expected cumulative monies available as a base for drawing retirement income will grow rapidly over the next 40 years. Table 1.1 shows Rice Warner Actuaries[2] projections for 15 years from June 2009. The post retirement market as a % of all assets grows from 20% to 35% in just 15 years while the nominal dollar value goes from $0.2bn to $1.5bn – a factor of seven.

Projection Results: Post-Retirement Market									
Market Segment	*Today*		*In 5 years*		*In 10 years*		*In 15 years*		*CAGR*
	30/06/2009		*30/06/2104*		*30/06/2019*		*30/06/2024*		
	($M)	(%)	($M)	(%)	($M)	(%)	($M)	(%)	(%)
Not for Profit Funds									
Corporate Funds	7,030	(3.3)	6,514	(1.4)	3,012	(0.3)	1,239	(0.1)	(10.9)
Industry Funds	18,810	(8.8)	76,113	(16.8)	193,560	(22.0)	367,429	(24.8)	21.9
Public Sector Funds	32,353	(15.1)	49,950	(11.0)	74,382	(8.5)	113,304	(7.7)	8.7
Subtotal Not for Profit Funds	*58,193*	*(27.2)*	*132,577*	*(29.2)*	*270,955*	*(30.9)*	*481,971*	*(32.6)*	*15.1*
Retail Funds	97,162	(45.4)	204,305	(45.0)	399,486	(45.5)	675,581	(45.7)	13.8
Self Managed Funds	58,693	(27.4)	117,068	(25.8)	207,698	(23.7)	321,312	(21.7)	12.0
Total Post Retirement Market	*214,048*		*453,950*		*878,139*		*1,478,864*		*13.8*
% of all Assets	*20%*		*25%*		*31%*		*35%*		

Source: Rice Warner, 2010

Table 1.1 Projected Size of the Post Retirement Market by Segment

1.6.3 Regulatory environment and Government policy

Superannuation and pensioners' income have been a high importance, high priority constant on Government's policy agenda for many years. In the last 18 months, the Cooper[3], Henry[4] and Ripoll[5] reviews and the government's responses – Stronger Super[6], A Tax Plan for our Future[7] and the Future of Financial Advice[8] (FOFA) have all shone a light on the often complex but always very public issue of the perceived high cost in aggregate of Australia's wealth management industry, including the superannuation and retirement incomes framework as it currently operates.

Assistant Treasurer Bill Shorten in his response to the Cooper Review recommendations says the government's Stronger Super program could lower fees by 40 per cent, potentially lifting the retirement savings of a 30 year old on average full-time wages by $40,000 or 7 per cent.

These reviews also highlighted that in specific subsections of the industry there can be (a) very high costs at a member level and (b) a serious lack of transparency. The very high costs do not greatly affect the average levels of costs, but it is critical that the highest relative costs are substantially reduced to ensure reasonable equity and fairness to members is achieved. It is these extremes which can destroy the industry's reputation and members' confidence in it. Reducing retirement income costs must include as a focus ensuring that the highest costs at member level are substantially reduced. Examples include the high cost to investors of entering certain investment products (e.g. Westpoint) and the implicit but often hidden costs of retail financial advice.

1.7 Retirement income costs versus value and benefits

In considering the reduction of retirement income costs, we need to be careful not to target only reducing costs without reference to the benefits that retirement income provision extends to members. At its core, any cost benefit equation seeks to provide value - that is strong benefits relative to the cost incurred. At the same time, we recognise that value is much more subjective than costs. Most costs are easily recognised, can be measured and hence can be monitored with scope for their reduction over time by taking actions.

For retirement income value is critical in assessing products and services which meet retirement needs. Top of the list is security of income and risk reduction around receiving such income. This comes at a higher cost, but provides an additional valued benefit. Service and utility aspects including range of choice, flexibility and control over elements of the retirement income benefits and ancillary services being offered.

At the same time we must be careful not to use value in the eyes of the provider as opposed to the member as a crutch for higher and less than transparent fees.

Cost in itself can include the expense relating to provision of the service and the core cost of that service. For example, for a retiree requiring a guaranteed income where a life insurer packages such a guarantee, that life insurer takes and uses its skills to manage investment and longevity risks. What we need is sufficient transparency so that true expense costs can be identified as such and compared across the marketplace.

1.8 Stakeholders

The financial and emotional effects of costs vary according to the stakeholder and the stakeholder's particular position at a point in time, the segment of the market and what they have a direct interest in. The objective of the whole superannuation system is the provision of adequate income in retirement, so the primary stakeholder is the member. Other key stakeholders are providers, trustees, administrators, fund managers, regulators and

government. The importance of cost relative to value and benefit will vary by stakeholder, and the stakeholders' particular circumstances. But the member must be the primary focus. This paper adopts that view and concentrates primarily on costs to the member and, in so doing, secondarily on the related costs to the provider in their provision of the retirement income to the retiree.

1.9 Guide to rest of paper

Section 2 examines what the costs are and where they arise.
Section 3 examines the issues affecting retirement income costs, what drives those costs including the functional areas in which they arise, and how those costs might be reduced going forward.
Section 4 suggests a target minimal cost framework for retirement income.
Section 5 draws conclusions and makes recommendations for actions to meet the goal of lower retirement income costs.

2 Superannuation and Retirement Income Costs

"The best way to keep loyalty in a man's heart is to keep money in his purse." – *Irish proverb*

2.1 Keeping money

The simplest way of keeping money is not to spend it in the first place. That means keeping costs to the minimum. But simplest does not necessarily mean the easiest. The industry too often relies on the message of hope that higher net investment returns after higher costs achieves the same or better outcomes. That's not unreasonable in itself if it eventuates, but it doesn't always and other elements such as different risk levels complicate the picture.

2.2 What are the costs?

2.2.1 Cooper Review costs data

The best place to start for any review of superannuation and retirement income costs are the submissions to, and commissioned investigations by, the Cooper Review.

Readers are encouraged to read the following key cost related reports submitted to the review:

(i) Rice Warner's Superannuation Fees Report 2008 for IFSA[9]
(ii) Deloitte's IFSA2009 International superannuation and pension fund fees report[10]
(iii) Deloitte's Default Super Costs under the MySuper Proposals[11]

The following submissions provide some additional perspective:

(iv) Chant West's December 2009 Phase 2 submission[12]
(v) Intech Investments' August 2009 Fees Survey[13]

These reports have collected and analysed the available market costs information and where necessary due to lack of data, have estimated current costs using the data available, discussions with industry participants and the authors' understanding of the markets. In a number of areas in (i) and (ii) the authors point out the gaps in the data and the care that needs to be taking in interpreting the statistics available, particularly in cross segment, cross product / fund design and cross country comparisons. As is usual in areas of such complexity and limitations, care needs to be taken in drawing conclusions from the data. However, by understanding these complexities, it is possible to form views on likely direction of costs in Australia and potential actions to reduce such costs over time, recognising the analysis cannot be as deep as one would like. The Cooper Review panel has based its recommendations for reducing costs on this data.

Table 2.1 shows Rice Warner's results for Australian Superannuation Fees and Expenses 2008 according to industry segment within sector. It splits the fees and expenses (i.e. costs to members) as a % of average assets across functional area.

Fees and Expenses By Superannuation Segment – Year to 30 June 2008							
Sector	*Segment*	*Administration %*	*Platform %*	*Investment Management %*	*Administration, Platform & Investment Management*	*Cost of Advice %*	*Total Fees %*
Wholesale	Corporate	0.24	-	0.47	0.71	0.02	0.73
	Corporate Super MasterTrust[1] (large)	0.20	0.01	0.56	0.78	0.02	0.79
	Industry	0.38	-	0.67	1.05	0.02	1.07
	Public Sector	0.21	-	0.46	0.67	0.02	0.69
Retail	Corporate Super MasterTrust[2] (small)[^]	0.41	0.43	0.81	1.66	0.46	2.12
	Personal Superannuation	0.17	0.61	0.70	1.47	0.53	2.00
	Retirement Income	0.20	0.42	0.69	1.31	0.53	1.84
	Retirement Savings Accounts	0.60	-	1.70	2.30	-	2.30
	Eligible Rollover Funds	2.03	-	0.47	2.49	-	2.49
Small Funds	Self Managed Super Funds	0.31	-	0.52	0.83	0.15	0.98
Total		*0.28*	*0.14*	*0.59*	*1.02*	*0.19*	*1.21*

[*] Expressed as a % of average assets over the year to June 30
[^] The difference between the 2008 values and 2006 values is the result of better data.
[1] Excludes employer plans with less than $5 million in assets.
[2] Employer plans with less than $5 million in assets.
Source: Rice Warner / IFSA, 2010

Table 2.1 Australian Superannuation Fees and Expenses 2008

The Retail Retirement Income line in the above table is almost entirely composed of account based pensions (88%) and thus is only a first pointer to the level of retirement income costs which will only accurately emerge when there is greater product diversity in retirement income including greater guarantees, longevity and life annuity-based products. The figure is for each area including platform and advice are similar in scale to personal superannuation or small, corporate super master trusts within retail.

Table 2.2 shows the equivalent international comparative figures for the administration and investment management functional components based on Deloitte's analysis. As Deloitte point out, international comparisons are difficult given different regulatory and related superannuation structure frameworks.

Country	*Admin Fees %*	*Investment Management Fees %*	*Total %*
USA – defined benefit	0.38	0.39	0.77
USA – defined contribution	0.01	1.01	1.02
Japan – defined benefit	0.04	0.15 – 0.46	0.19 – 0.50
Japan– defined contribution	0.32	0.20 – 1.50	0.52 – 1.82
UK	0.40	0.20 – 0.50	0.60 – 0.90
Netherlands	0.19	0.20	0.39
Australia – stand alone	0.24	0.47	0.71
Australia – large corporate master trusts	0.20	0.56	0.76

Note: All fees above are expressed as a percentage of assets (p.a.).
Sources. ICI Perspective (December 2008), 401ksource.com (2008), Deloitte Japan, Deloitte UK, Bikker (2006), Rice Warner (2008); Total report source: Deloitte/IFSA (2009)

Table 2.2 International superannuation and pension fund fees report

The Australian figures in Table 2.2 were taken directly by Deloitte from the Rice Warner figures (see Table 2.1) being the Wholesale Corporate and Corporate Super Master Trust (large) figures for the administration (excluding platforms) and investment management subdivisions.

Table 2.3 shows Rice Warner's calculation of annual fees for Australian Retail (for-profit) Post Retirement Income Products (Ref 9 #10, Cooper Ref 3 #7-2.4.1) according to account balance within allocated pensions and separately for guaranteed annuities.

Fees for pension products						
Allocated Pension Account Balance	*Assets*	*Administration*	*Platform*	*Investment Management*	*Advisor*	*Expense rate*
	($M)	(%)	(%)	(%)	(%)	(%)
> $1million	4,166	0.01	0.33	0.63	0.53	1.51
$500,000 - $1million	12,633	0.01	0.38	0.68	0.53	1.60
$250,000 - $500,000	21,026	0.02	0.44	0.73	0.53	1.73
$100,000 - $250,000	25,435	0.05	0.51	0.79	0.56	1.73
$50,000 - $100,000	9,995	0.10	0.58	0.85	0.63	2.16
$25,000 - $50,000	2,802	0.22	0.67	0.92	0.73	2.54
< $25,000	465	0.99	0.77	0.98	1.17	3.91
Total allocated pensions	*76,521*	*0.05*	*0.48*	*0.76*	*0.57*	*1.86*
Guaranteed annuities	10,392	1.25	-	0.20	0.25	1.70
Total retail post retirement	*86,913*	*0.20*	*0.42*	*0.69*	*0.58*	*1.84*

Source: Rice Warner, Superannuation Fees report 2008, December 2008 for IFSA

Table 2.3 Fees for Australian Retail (for-profit) Post Retirement Income Products

Unfortunately, there is a dearth of retirement income costs data publicly available beyond this in Australia and overseas, so my assessment are based on the data as presented here and my understanding on the nature of retirement income current and potential products, processes and related supply chain logistics.

This lack of data around retirement income costs has led me to identify and address the fundamental cost drivers in retirement income provision compared to accumulation, based on the issues in the industry and the functional areas in which costs arise. This analysis is set out in section 3.

2.2.2 Cooper comments on retirement income costs

Cooper made the following additional comments on these fees based on these retirement income costs analyses and submissions. This has set strong expectations for reductions in retirement income costs:

- "While, typically, the fees charged by not for profit funds on such products are lower, the bulk of post retirement assets are managed by the for profit sector.

- Chant West also notes that fees paid on post retirement products in the not for profit sector are higher than those paid on accumulation accounts.

- These fees are around 50 per cent higher than those in the accumulation phase and average fees for superannuation products as a whole, on a percentage of assets basis.

- The main factors creating higher fees in post retirement products seem to be advice and product complexity. In addition and perhaps related, this segment is highly 'retail' and individualised in contrast to the accumulation phase where employers or other associations may bargain on behalf of employees. It follows that the fees in this segment are broadly similar to those in the personal retail area.

- On most account balances, fees in the post-retirement phase are higher than for personal accumulation plans. It is not until account balances reach about $100,000 that fees become similar. However, as the average balance in post retirement products is much higher, the average fee as a percentage of assets is lower."

2.2.3 Cooper conclusions on retirement income costs

"The Panel doubts whether the higher fees for allocated pensions are justifiable. There may be some additional complexity in post-retirement products that justifies the additional fees. This could benefit from further examination.

The Panel considers there is scope for these fees to be reduced substantially. The following policy responses are designed to deliver these reductions:

▪ the introduction of MySuper products and the requirement that those products have a retirement income stream component should help build scale and place more emphasis on products' financial returns to members; and

▪ the Government's decision to ban commissions under the FOFA package should help ensure planners recommend retirement income products that offer good value for money."

The lack of product diversity and related lack of data on fees and costs for non account based non legacy retirement income meant Cooper couldn't draw any further conclusions at this point, so as an industry we need to build such products and access to related fee and cost data going forward to help drive innovation at minimal costs to retirees.

2.3 Where do the costs arise?

2.3.1 Functional splits

As the tables above set out, at a base level the costs can be separated functionally into:

- Administration including Platform provision
- Investment
- Advice

To better understand the costs and how to reduce them, each of these can further be broken down into functional sub areas as shown in Table 2.4.

Administration - Back office	*Administration Middle office*	*Administration Front office*	*Investments*	*Advice*
Member records Contributions processing Benefits processing IT&T incl admin & other systems Fund accounting Investments Custody	Financial oversight incl. treasury Strategic and operational management Risk management Product development	Distribution Sales Member service	Asset consulting (Asset allocation) Investment management (Asset selection and monitoring)	Education Intra-fund (simple / low cost) Advice Financial planning

Table 2.4 Functional Cost areas and sub-areas

2.4 Industry sectors, platform and advice components

The cost of each of these functional areas differs considerably in accordance with the business model of the provider. The differences are most apparent between wholesale and retail sectors. Based on volume of members affected the most important segments for comparison and analysis are between retail retirement incomes and industry funds.

As is clear from the separation of the platform and advice components in Table 2.1, the use of a platform model adds a significant additional cost (notwithstanding any benefits claimed for this approach). So also does the bundling of advice and the historical payment for this advice via higher funds under management fees to fund commissions to meet the cost of the advice as well as advisors' and providers' profit margins. The FOFA reforms which include the banning of commission will make this advice cost separate and hence more transparent. In aggregate that will reduce aggregate advice costs as those not requiring advice will not now be forced by default to pay for what they didn't really use.

Financial advice is a very important piece of the retiree's needs. Many individuals, particularly those in lower socio-economic groups will benefit from seeking simple financial advice for the first time as they approach retirement.

2.5 Dollar vs % costs; variation by age – Accumulation vs Retirement Income

As a starting point, it is reasonable to expect that retirement income costs in dollar terms are in relative terms higher than accumulation costs reflecting several interacting factors including

(i) lower volumes
(ii) a higher administration load from making payments rather than receiving contributions
(iii) greater product complexity
(iv) no tax relief on expenses.

The greater advantage of no tax is higher net of (zero) tax investment returns from less tax "costs" and full receipt of franking credits.

As members approach retirement and in the early years of retirement, they are still in the net accumulation stage. Contributions and investment earnings add to members balances over time. This means that $ costs and costs as a % of funds under management (FUM) are very different for a 30 year old compared to a 65 year old. All else being equal with growing balances per member we'd expect retirement income costs as a % of FUM to decrease significantly with time simply due to the increasing account balance. Account balance size is a broad proxy for age. But the contrary evidence, as noted above by the Cooper Review, suggests this is overcome partly by greater product complexity and partly by the retail for-profit base that dominates retirement income sales to individuals. To reduce real costs we need to drill down and focus on reducing / containing dollar costs.

3 Issues affecting and drivers of Retirement Income costs

"When a person with experience meets a person with money, the person with experience will get the money and the person with the money will get some experience." - *Leonard Lauder*

3.1 Drivers of Retirement Income costs

At a high level, the key drivers around cost and potential cost reduction are:

1. Business model, including:
    a. wholesale / industry / retail, strategy, markets
    b. distribution channel(s) and advice model
2. Scale and volume
3. Operational model – extent of efficiency
4. Operational model – extent of complexity, including:
    a. nature of retirement income products
    b. defined contribution vs defined benefit
5. Investing - active versus passive
6. Investing - asset allocation and access

Essentially, these drivers are, what makes a retirement income product, or the process and supply chain logistics around delivering a retirement income, expensive or not.

To minimise retirement income costs requires a deep understanding of how these cost drivers affect a provider of retirement income's current business and an assessment of how to change the products, processes and supply chain to optimise the cost benefit equation and in so doing reduce costs for members and providers.

3.2 Key current issues affecting retirement income costs

As stated in section 1.5:

Issues affecting accumulation and retirement income costs

1. Costs are too high
2. Lack of transparency around costs
3. Too many clipping the ticket too often at too high a price
4. Cost and value of provision of advice
5. Rise of the SMSF

Issues specifically affecting retirement income costs

6. Retention of members before and during transition to retirement
7. Limited product and service range for retirement income
8. Lack of Government action to support greater diversity of retirement income products - around investment and longevity based guarantees.

3.3 Assessment of issues and how they are affected by cost drivers

3.3.1 Approach taken

I have considered for each of these key issues, how the cost drivers behind them might affect retirement income costs and in the process, where relevant, compare this to the effect on accumulation. I have considered the functional areas in which the costs arise, and how those

costs might be reduced going forward. The costs equation is a web of interactions across issues, drivers and functional areas.

Section 3.4 discusses each of these issues in turn providing background and an initial assessment.

3.3.2 Greatest potential for cost reduction – four selected cost drivers for action

I have identified what I consider to be the four aspects where there is greatest potential for cost reduction for retirement incomes. These are:

1. Scale & volume
2. Investment – Passive vs active
3. Government support for retirement income product diversity
4. Advice paid by flat dollar fees

Section 3.5 takes each of these four cost drivers in turn and:

(i) Provides further specific analysis from that provided in the issues discussion in section 3.4
(ii) Identifies cost reduction actions
(iii) Suggests reasons
(iv) States the expected effects of those actions.

3.3.3 Further potential cost reductions

Section 3.6 considers several other aspects of provision of retirement income where costs could be reduced, but in less depth. These aspects emerged from my systematic consideration of the functional operations of a provider in the retirement income space. For each of these aspects which are in themselves cost drivers, further specific analysis from that provided in the issues discussion in section 3.4 is provided and cost reduction actions identified.

3.4 Costs issues discussion – by issue

3.4.1 Issue 1 - Costs are too high

Cooper conclusions

The Cooper Review stated:

- "Treasury estimates that the MySuper and SuperStream proposals would, in the long run, see a cut of around 40 per cent in fees for the average member." (Ref 3 #1.14 p3)
- "The Panel doubts whether the higher fees for allocated pensions are justifiable." "The Panel considers there is scope for these fees to be reduced substantially." (Ref 3 #7-2.4.1 p204)

While 40% is very ambitious target and has a lot of dependencies, my conclusion from reviewing the Cooper Review inputs, analysis and conclusions is that superannuation cost levels in general, are higher than they could and should be across most of the superannuation spectrum particularly in the retail sector. This includes most elements of retirement income.

The immediate drivers Cooper sees for lower costs that I see are directly relevant to retirement incomes are:

(a) MySuper accounts must include a retirement income stream component
(b) SuperStream - Automation of the back office, particularly around use of e-commerce and use of tax file number as the primary identifier for consolidation of superannuation accounts will help avoid proliferation of retirement income accounts, going forward (although much less of a problem than for accumulation)
(c) Scale - the benefits of automation are increased. Current and new costs are spread over a wider base

(d) Banning of commissions and related FOFA package measures.

Some general observations on retirement income cost trends

Retirement income provision, with the emphasis on the *income*, is in its infancy in Australia, and it will take several years of research, innovation, increased diversity of product, capital investment, increased competition and scale to get to the "first base" of a truly sustainable competitive retirement incomes market. Only then can all areas of cost reduction / containment arising from the provision of such income payments be fully addressed. In the meantime, the industry must seek to be innovative in containing development and implementation costs.

In the near term, as the Government's Stronger Super package drives implementation of the Cooper reforms, but mostly due to the continuously increasing size of the superannuation pool, the costs in the industry as a percentage of FUM are likely to continue to fall slowly as has been the trend for the last six years (Ref 9 #1.3.3 Table 3 p6). Dollar costs per member are unlikely to fall in nominal dollar terms, given an ever increasing expectation around service levels but should fall in real terms after inflation for at least several years as inefficiencies are eliminated, and greater scale is achieved. Countering that will be the cost of investments in new and improved systems supporting SuperStream and backing new products – both MySuper, where change should be minimal particularly for industry funds - and new retirement income products to meet retirees' need.

The high cost of advice in relative terms, having high labour cost input and high governance requirements will need to be met including directly by members. This is a potentially significant cost, for people approaching retirement, and in their early years of retirement. The new era of no commissions and the availability of simple low-cost, including but not limited to intra fund advice, will improve costs and benefits around advice.

3.4.2 Issue 2 - Lack of transparency around costs

Of all the cost reduction possibilities, the lack of transparency around costs is the one that riles the most. It is wrong to hide such important matters from purchasers of products or services. As actuaries with a long professional history we have preached fairness and equity for close to two hundred years. Yet in our retirement income roles as product developers we can still fall into the trap of making products more complicated than they need to be or by devising elaborate cost recovery schemes to support the product development costs and profit margins. We may then, in common with the industry, fail to communicate all the costs clearly – member fees and charges, explicit and implicit. If as individuals and as an industry we so fail to communicate, we are ultimately failing the member. That is our professional challenge.

The third of Cooper's 10 Super Principles states that "Transparency and disclosure are essential for the effective operation of the system, but are not substitutes for well-designed products that work in members interests." Both are essential for an optimal system. From a purely costs perspective clarity and fullness of information around fees and charges facilitates comparison and determination of best value, thus empowering the member to choose what best suits their needs and budget. Remembering too that the dollar costs of a product including advice for a retiree can be in $000s of dollars - very large. Transparency helps competition on price, innovation in product and service ideas and implementation.

The FOFA reforms which include the banning of commission will make advice cost separate from administration costs and hence more transparent. In aggregate that will reduce advice costs as those not requiring advice will not now be forced by default to pay for what they didn't really use.

Retirement income provision in general requires more complex products, which increases costs and simultaneously results in reduced transparency to members around costs versus benefits. We need to find ways to explain better the guarantees, risks and the explicit costs to members when the industry sells complex products like variable annuities. For example, why is it a 1% or a 3% fee for the guarantee? How can this be broken down into components to better explain the costs to the member of the service being provided? We need sufficient information to be disclosed to compare like with like components of products so members and advisers can truly understand what is driving the costs and members can decide to purchase or not based on all the cost and benefit facts.

Increased transparency in the superannuation supply chain, including specifically in retirement income provision will increase competition and hence in the long run drive lower pricing, as well as being fair to members.

3.4.3 Issue 3 - Too many clipping the ticket too often at too high a price per clip

This is perhaps a dangerously generalised statement but has been included as an industry issue to focus attention on the fact that there are a lot of costs and fees in the system – some are not immediately apparent and they add up, often to be significant. Most specific cost issues are addressed in this paper through *Issue 1 - Costs are too high* and most transparency issues are addressed through *Issue 2 - Lack of transparency around costs.* Addressing those reduces the residual cost reduction challenge. FOFA enforces transparency and elimination of commission, driving a move to a fee for service model which will reduce the extent of unwanted advice related fees. The main remaining opaque area to members is platforms.

Heightened awareness of the costs of platform elements should in theory increase the pressure to lessen these costs. However, the banks, coupled with wealth manager AMP/AXA, dominate the platform landscape and the related distribution from the adviser market, in superannuation and more widely in wealth management. The incentive for those providers is to retain and build on that distribution which rewards advisers financially and through improved administration services. Reducing costs for the member/investor is down the priority list, notwithstanding the importance of this for the provider's own profitability and competitiveness. The current limited pricing friction is likely to remain and reductions in costs may not occur. It is hard to see any major new distribution model emerging in the short term.

The Rice Warner expense analysis (Table 2.2) shows that platform fees and expenses, which apply almost exclusively to the retail market, comprise 0.42% for retirement income products (being 88% account based pensions) and 0.61% for personal superannuation. These are large costs reducing members' net returns.

Providers, fund managers and advisor users of a platform can take several "clips" of the funds under management ticket with many members not being fully aware of the extent of fee taking and the purpose of each clip. An example is fund of fund arrangements with a full wholesale/retail/adviser supply chain.

The retail distribution model via advisers and platforms has a high cost to members but the client "capture' drive is very strong.

However increased transparency will enable members and potential members to choose or switch from higher to lower cost providers on a more factual basis. Non account based retirement income products will become available on platforms but with much greater adviser and intra fund advice given its complexity, choice and substantial member capital investment, as well as provider product development and sales and marketing costs.

See section 3.6.2 *Distribution & Advice including Platforms* for cost reduction actions.

3.4.4 Issue 4 - Cost and value of provision of advice

Between the Govt.'s FOFA proposed legislation and the Stronger Super implementation we will see the elimination of commissions, the need for a member to opt in annually to continue to be serviced (unless watered down before enactment) and the need to demonstrate value in fee-for-service. This is already radically changing the advice market. From a cost prospective most critically it will eliminate many members being charged for a service they do not receive or are unaware of. Fee for service and fixed fee intra-fund advice will enable easier comparison between retail and industry funds. This will lead to further competition and given the growing volume of funds likely to be "under advice" will also lead to more innovation and efficiencies around advice cost reduction.

Retirement income provision will benefit in the value sense from the provision of simple intra fund advice to members, with lower levels of balances who otherwise would not receive such advice. But advice costs money, no matter how minimal, and this will serve to increase costs for those members, albeit more likely to be value for money.

Currently most of those with lower balances find full financial planning unaffordable and poor value, so are shut out of getting advice. There is a huge need and gap in the market for intra fund and low cost advice especially approaching retirement. Most industry funds have only recently started to cater for this as the numbers of new pensioners with other than very small balances has been limited. Member retirement account balances will grow as the super system matures, thus enabling more spreading of the costs load but also necessitating additional advice work volume.

3.4.5 Issue 5 - Rise of the SMSF

The rise of the SMSF is a double edged sword for the industry. Liberating for member trustees and making new opportunities for providers of investments and administration but potentially a continuing loss of providers' funds under management and a reduction in their expense contribution base, as members with large fund balances decide or are persuaded to start their own SMSFs.

SMSFs will continue to grow as individuals accumulate more wealth, as they approach retirement and into early retirement, due to:

(a) the member retains direct control and takes great interest in / sharper focus on costs as well as outcomes
(b) there is much greater transparency than for a member in a third-party fund
(c) cost reductions within investments - from the scale of the market, from a sharper focus on the cost benefit of active versus passive investing, and the trickling down of all of these benefits to products which are competitive and available to SMSF investors.
(d) The further development of competitively priced SMSF products by industry and retail funds to ensure their retention of the high member balances.

SMSFs have the potential to become the greatest purchasers of retirement income products in the future given their high balances, and should be attached to the strong brands of the largest wealth managers.

3.4.6 Issue 6 - Retention of members before and during transition to retirement

Retention of members before and during transition to retirement is critical to fund long-term viability. Funds cannot afford losing these relatively high balance members as they preserve the fund's scale and make a critical contribution to the fixed cost base of the fund.

Once a member is lost from a fund to another fund it is difficult and expensive to regain the confidence of that member further down the track to rejoin. They've made their decision.

An investment of time and effort to avoid losing members is likely to be considerably less than the cost of acquiring new members.

3.4.7 Issue 7 - Limited product and service range for retirement income

The Henry Review recognised that as people live longer, they will require more options to manage their assets in retirement. Cooper notes "that post retirement product innovation, while showing promising signs, is still at a relatively embryonic stage, in Australia."

As the volume of members reaching retirement age increases, and the accumulated superannuation balances of those individuals increase with the maturing of the superannuation system, there urgently needs to be both an increased range of retirement income products and innovation to drive development of such products. Products are needed to better address the key risks around investment markets, inflation and longevity, and assuage estate concerns. Products with greater guarantees, insurance against longevity, life annuity-based products and less market volatility are required to meet retirees' needs for security of income and peace of mind to complement the existing market linked products.

Diversity of product will generate considerable additional costs initially as new products are developed, given the complexity of the longevity and guarantee elements at work. In due course, as volume of retirees and product builds, there will be a commensurate reduction in costs for those products, however with a considerable time lag, given the current departure point.

To contain costs and ensure competitive, value pricing, Australia should draw on overseas experience but be very aware of the markets and regulatory differences. Spreading of development costs across several providers should be pursued where it doesn't conflict with competition and a provider's strategic goals.

Another less costly development would be to have products with greater emphasis on portfolio construction to produce lower risk income streams from equities and fixed interest including inflation linked to fixed interest. Retail and industry funds can offer packages to their own members and SMSFs.

The government and major banks, and the superannuation industry should cooperate to devise pragmatic, low-risk, lower cost infrastructure and related capital investment securities/bonds which are long-term in nature, and well-suited to long-term liabilities of superannuation funds and the lower risk, income important requirements of retirees.

3.4.8 Issue 8 – Lack of Government action to support greater diversity of retirement income products

As noted in the previous section both Henry and Cooper see the need for a range of retirement income options to combat investment, longevity & inflation risks.

Henry found that the private sector is better placed to develop retirement income products but that the public sector can assist by providing more tools to limit risk and recommended the government take action to (Ref 4 Recommendation 21):

(i) Remove constraining SIS Regulations e.g. so that deferred annuities are allowed
(ii) Issue long-term securities
(iii) Make available the data needed to create and maintain a longevity index.

Cooper supports the seeking of greater flexibility within the system and also states it will be important for regulators to avoid becoming inhibitors to innovation through unnecessarily rigid rules. Rules around eligibility, social security, tax, capital requirements and product

design approval must all be supportive and sensible balancing risk to members and the benefits of better products.

Allowing deferred annuities, so that product providers can be innovative around offering guaranteed income for life benefits starting at ages between say 75 and 85 would not be as costly to members. It would enable the rest (the bulk) of their capital to be used for their active retirement period up to those ages.

As increasing numbers of retirees are expected to live beyond 100, government bonds of at most 15 years need to be supplemented by bonds of up to 50 or more years duration to match the liabilities to significantly reduce risk in pricing. To reduce inflation risk for member and provider, inflation linked (capital) government. bonds should also be created for these ultra long durations.

These and similar actions reduce the risk and also the cost and expense of managing the risk and administering that risk management.

The Institute of Actuaries of Australia has emphasised the critical importance of many of these reforms in its 2011 Pre Budget Submission[14].

See section 3.5.3 *Government support for retirement income product diversity* for cost reduction actions.

3.5 Greatest potential for cost reduction – four selected cost drivers for action

3.5.1 Scale & volume

Functional area: Administration - Middle Office

Primary Issue: Issue 1 – Costs are too high
Secondary Issue: Issue 6 – Retention of members

Analysis

1 Cooper:

Cooper and several submissions found scale – usually measured as FUM – is reflected in lower fees as a % of FUM by entity and by member account balance. As Cooper says "Scale matters" and the system is still immature for is size – so its scale capabilities have yet to be reached. (Ref 3 #1.6 p1, #7-2.4.1 p203/4 etc)

2 Rice Warner:

Evidence in the fee tables reproduced in section 2 of this paper and originally right through RW's fees report to IFSA. (Ref 9 All)

3 Deloitte:

(i) In comparing Dutch and Australian administrative costs per account shows steady reductions up to a fund's assets being $1bn (Dutch) to $7bn (Australian). (Ref 10 Executive Summary p6)

(ii) Scale benefits exist for large funds in Australia but are a greater for the very large funds in the US, Japan and Europe. (Ref 10 Executive Summary p8)

(iii) Conclusion – scale is critical to achieving lower fees. There are sectors including the corporate and industry fund sectors where further rationalisation will provide more benefits. Tables in #3 of illustrate the reductions in both administration and investment fees as FUM increases.

4 Chant West:

Larger funds do enjoy economies of scale, and investment managers operate on progressively lower profit margins. (Ref 12 p28).

This scale applies to all functional areas – administration, platform, investments and advice. It is strongest in the administration area, where there is a strong fixed overhead component. (See Table 2.3).

Cost reduction actions

1. Pursue a merger and/or acquisition strategy. Target most culturally alike funds to increase the chance of successful implementation.
2. Implement a member retention strategy to encourage members to stay until retirement.
3. Implement a sufficiently diverse product range at retirement to encourage retention of member at and through retirement.
4. Where possible, outsource and/or co-develop functions especially IT systems including new product administration, platforms and advice systems, to the extent strategic confidence and flexibility is maintained.
5. Review existing processes and practice against global best practice and re-engineer to take advantage of new technology in particular. Tailor it to Australian needs

Reasons & effects

1. The greater the scale up to a very high level - the lower per member cost, the greater the cost reductions for members being "acquired" and the more potential for improved services for members.
2. The greater the capacity to invest in new retirement income product development.
3. The greater the risk reduction from diversification across more sectors.
4. The greater the bargaining power in negotiating investment management contracts.

5. The greater the bargaining power in negotiating joint venture developments around new products, new distribution, enhanced platforms and new advice models, all of which could ultimately reduce costs for the retiring or retired members.
6. The greater the access to potentially higher yielding alternative investments such as private equity and infrastructure.

3.5.2 Investment – Passive vs active

Functional area: Administration - Back Office

Primary Issue: Issue 1 – Costs are too high

Analysis

The Cooper Review states: "Our decision to include passive investment in the analysis does not imply any statement from us on the pros and cons of active versus passive. Rather, it is a fact that funds can invest passively at much lower cost." It also identifies that passive or indexed investment "is more popular overseas than in Australia."

Active investment management costs more than passive investment management. Yet over many years, performance surveys and analysis in Australia and overseas suggest that returns after fees and charges for the median fund in deep, actively traded markets, more often than not fail to beat the relevant benchmark indices. See:

(i) Standard & Poor's Indices Versus Active Funds Scorecard (SPIVA®)[15] for Year end 2010 for Australia shows:
   a. The S&P/ASX 200 Accumulation Index has outperformed approximately 71% of active Australian Equity General Funds over the last 5 years.
   b. Over a five-year period, the MSCI World ex Australia Index has outperformed approximately 74% of actively managed international equity funds.
   c. At least 80% of active Australian Bond funds have failed to beat the UBS Composite Bond Index benchmark over periods of three years or more.

(ii) Standard & Poor's SPIVA report for year end 2010 for the U.S.[16] is not clear cut on the issue – the results vary between money and asset weighted. However a majority of the classifications listed in its Report 1 for the U.S. for 5 years have benchmarks outperforming U.S. equity funds.

(iii) Australian Financial Review Article of Sep18-19 2010 by Barry Dunstan "Clever Money follows index funds"[17] found a minority of Australian funds survived and outperformed the indexes, based on a report from the Vanguard Group. The Vanguard paper was reported as stating that the index outperformance stems from low cost, broad diversification, low cash drag and a potential for tax efficiency.

The incumbent asset management industry has a strong vested interest in promoting active investment management and in keeping fees and charges as a percentage of funds under management. And of course, given statistical variation, many managers will beat the index while many others will not. The sales pitch is the promise of beating the index not the actual outcome. In reducing investment management costs, the extent to which a fund uses a passive rather than an active strategy is the most important consideration. However from a value perspective it is not the only one – consider also the ability to access greater diversity, achieve a better balanced risk profile, or exploit arbitrage opportunities in under researched, illiquid, immature or specialist markets, such as for example small caps in Australia.

We note that AustralianSuper, the largest industry fund in the country, is further down this path than most of its Australian peers with a 50% indexed exposure to Australian equities.

Data in the Deloitte report for Cooper estimate the difference between MySuper passive and active (excluding alternatives) costs for a balanced fund as around 30bp (Ref 11 Part 1 p19).

Cooper has made it a requirement of trustees to target after tax returns. An important ingredient of after tax efficiency is reduced trading levels thus generating fewer capital gains within 12 months of purchase, where no discount is available. Trustees must also justify their decisions to pursue an active investment policy by the need to demonstrate value for members. Cooper also notes "the recent development of the 'FTSE ASFA Australia Index Series', which covers the Australian equity market and is designed to better align investment decisions with tax positions." There are plans to create exchange traded funds (ETF), based on this benchmark index, which will make it easier for members, particularly via SMSFs, and providers to passively invest to meet low cost after-tax return objectives.

RI cost reduction action:

1. Take a passive approach for core holdings for a considerably greater percentage of FUM. Target 50% of highly liquid actively traded markets. Use low cost indexed funds for this purpose. Can still manage the remaining 50% actively as "satellite" funds.
2. Reduced trading levels, to reduce transaction costs, and reduce tax.

Reasons & effects

1. Most critically – will reduce investment management fees by up to 15bp p.a. (50% of 30bp) for a balanced fund.
2. Will reduce trading costs as there is much less need to trade – more of a buy and hold strategy.
3. Should assist in reducing tax, including less short term capital gains and more deferral of tax on gains, thus increasing net after tax returns all else being equal.
4. Less oversight, monitoring and risk management around investment policy implementation – so less investment management operational costs.
5. Less deviation from market benchmarks, so potentially less deviation from members' expectations.

3.5.3 Government support for retirement income product diversity

Functional area:	Administration - Middle Office
Primary Issue:	Issue 8 Lack of Govt action to support greater retirement income product diversity
Secondary Issue:	Issue 7– Limited product and service range for retirement income

Analysis

Section 3.4.7 covering Issue 7 - Limited product diversity and section 3.4.8 - Lack of Government action to support that diversity, have earlier set out the analysis relating to this topic.

Cost reduction actions

To facilitate retirement income product innovation and diversity and build momentum and scale in that space, the Australian Government should urgently implement selected recommendations by the Henry Review and related recommendations from the Institute of Actuaries of Australia 2011 Pre-Budget Submission:

1. Revise SIS Regulations which limit annuity design
2. Remove unfavourable treatment of annuities under Aged Care and Centrelink rules
3. Issue very long-term fixed duration bonds, including up to 30, 40 and 50 years to enable much improved asset –liability matching for new retirement income products. (The UK and France started issuing 50 yr bonds in 2008.) .
4. Issue very long-term index linked bonds, including up to 30, 40 and 50 years
5. For both types of securities it should issue sufficient volume, and encourage a secondary market, to assist in liquidity and lower costs of acquisition and selling

6. Allow annuities & deferred annuities as part of account based pension
7. Change tax rules so a deferred annuity taken in the drawdown phase is regarded as a pension for tax purposes
8. Develop a clear regulatory framework for variable annuity products
9. Develop a longevity index for the Australian population and encourage the development of a market in longevity bonds.

Reasons & effects

1. Meets core needs of retirees in providing long-term stable inflation linked and fixed income streams
2. Encourages innovation of product in the financial markets and ultimately by providers for members in structured finance and longevity
3. Enables competitive, value products at higher volumes and less cost in the longer term
4. Enhance Australia's reputation as an innovative financial services centre.

3.5.4 Advice paid by flat dollar fees

Functional area: Advice

Primary Issue: Issue 4 – Cost and value of provision of advice

Analysis

The discussions in section 3.4.4 - *Issue 4 - Cost and Value of Provision of Advice* discussed the government's proposed FOFA and Stronger Super implementations, which will see the elimination of commissions, members opt in annually and the need to demonstrate value.
Cooper recommended that trustees are required to proactively offer intra-fund advice to MySuper members as they approach retirement age. (Ref 3 p208).

RI cost reduction action:

1. Strong implementation of intra fund / simple advice at explicit low $ fees across industry funds.
2. Retail funds to develop low cost limited advice as a new alternative option for their members with automatic notifications/referrals to advisers/planners for more comprehensive financial planning where requested.
3. This low cost advice framework will also support industry funds extending their range of retirement income products while bearing in mind the ultimate, albeit low level, safety net of the Age Pension.
4. Provide access for own members to basic advice using advice templates based on segments by age and account balance, with clearly set out fixed costs in $ terms not as % of assets, on a fee for service basis.
5. Template to cover
   (i) Approaching retirement
   (ii) Transitioning to retirement
   (iii) First decade of retirement
   (iv) Post age 75.

   Such a template approach by segment within the retirement market should help to charge dollar fees.
6. Consider joint development of support systems with other provider(s) to spread cost.

Reasons & effects

1. Flat dollar fee, rather than a % of assets, sharpens the focus for member and provider.
2. Flat dollar fee for intra fund advice will enable access at relatively low cost and provide value.
3. Transparent so member knows cost so can make value decision on use. No surprises – honesty and integrity by provider and adviser.

4. No commissions, no related conflicts of interest and regular opt in checkpoints should help substantially reduce overselling and misselling, thus saving members money.
5. Increases likelihood of retaining member in fund which helps scale and spreading of overhead costs.

3.6 Further potential cost reductions

3.6.1 Contributions & Benefit processing, IT&T

Functional area: Administration - Back Office

Primary Issue: Issue 1 – Costs are too high

Analysis
From the retirement incomes perspective contributions only occur during transition to retirement. So the contribution aspects of the SuperStream e-commerce reforms will have limited effect on retirement costs.
Full automation of benefit payments via payments system is largely in place already so only small improvements.
Potential for rapid automated notification of death to provider via TFN and payments system to reduces pensioner alive verification costs and times, but it will be many years before volumes of deaths of retirees get to significant levels.

RI cost reduction action:
1. Mirror Cooper / Stronger Super SuperStream recommendations into Retirement Income space.
    a. Use e-commerce platform to maximise retirement income payments efficiencies
    b. Use of TFN as identifier
    c. Via above, potentially faster auto-notification from Bank and ATO of death of annuitant / pensioner.
2. Focus on dollar costs – charge all admin fees as dollar.
3. Share IT system development costs via 3rd party or via shared administrator.

Reasons & effects
1. SuperStream
    a. No cash drag for members.
    b. Unique and reliable – reduces manual time
    c. Reduced risk of paying deceased person in error. Earlier notification.
    d. Less costly human intervention.
2. Keeps sharper focus on costs for provider and member.
3. Flexible, maintainable, robust retirement income product support systems are expensive to build. Lower cost per member.
4. Need to build scale.

3.6.2 Distribution & Advice including Platforms

Functional area: Administration - Front Office

Primary Issue: Issue 1 – Costs are too high
Secondary Issues: Issue 3 – Too many clipping the ticket too often at too high a price
Issue 2 – Lack of transparency around costs

Analysis

The latter part of Section 3.4.3 *Too many clipping the ticket too often at too high a price per clip* covered the analysis ground on platforms' contribution to costs and the scope and challenge of reducing those costs.

Cost reduction action:
1. If platforms are a key part of business model, have a single all embracing platform - rationalise existing platforms and products into a single modern efficient and flexible one.

2. Reduce the incidence and complexity of multi-level fund of fund arrangements. Perhaps limit to no more than one level, enabling direct pass through instead so less clips.
3. FOFA implementation will reduce and make transparent and force justification of the advice clips.
4. Avoid overcomplicating the platforms with nice to haves that add complexity rather than meet a true need or value add.
5. Consider eliminating platform shelf-space fees.
6. If platforms not a key part of business model, avoid them and replicate only core elements re investment choice within own fund.
7. Open direct channels to people with higher net worth/balances and SMSFs. Reduce platform % fees to those high account balance members to attract and retain them.
8. Get scale cost reduction benefits per member from significantly increasing retail fund simple intra-fund advice options, with on referrals for complex advice.
9. A greater passive investment allocation reduces the clip of the asset management industry.

Reasons & effects

1. Just one platform system to maintain and enhance.
2. Get scale benefits – lower cost per member covered.
3. Minimise intermediary clipping of tickets.
4. Provide similar core benefits without cost and complication of platform delivery and clipping of ticket / cost by multiple parties – BDM/sales at provider, financial advisers, fund managers, platform providers.
5. Build and retain scale enabling lower costs per member.

3.6.3 Investment – asset management fees

Functional area: Investments

Primary Issue: Issue 1 – Costs are too high
Secondary Issue: Issue 2 – Lack of transparency around costs

Analysis

In recent years fixed dollar disclosures on member statements have revealed the large $ costs to members of the investment management organised by providers with asset managers on members' behalf. These investment management costs can be high and from the members' perspective and for most providers they rise with the account balances – not just with the investment returns. The fundamental question is what arrangement / structure provides the best service – i.e. the best net investment return after tax and fees for the member - while at the same time providing an equitable incentive to the asset manager to perform well, ensure a long term, stable and productive relationship to the benefit of all parties. This includes soundly running an asset management business which can recruit, train and fairly reward people with the specialist investment skills needed.

There is wide variety around investment fees but fees as a % of assets is deeply entrenched. (see Ref 13). As reflected in the passive vs active debate, there is also a lot of discussion around what level of value asset managers provide over longer time horizons for the fees they earn. Given the volatility of markets it is very hard to pick future asset manager winners on value. Past winners may be just that. The high remuneration levels in the industry reflect how market movements, skill and luck can lead to big investment gains, or not. Reputation is critical and can be cult like. Trustees need to keep a view of the bigger picture and apply a rigorous and disciplined selection and monitoring process as well as using commonsense.

RI cost reduction action:

1. Use investment manager(s) that charge base dollar fees - not as a % of funds under management - as majority of remuneration.
2. Can still incorporate a reasonable but not excessive level of incentive based on target absolute and/or excess of benchmark performance once interests of member, provider and fund manager are aligned.
3. The large and growing global scale asset management market in Australia may attract global or local businesses with deep pockets who see an opportunity to offer more competitive, more transparent value based asset management fee arrangements. The GFC has distracted most world players for the last few years but that will pass. In Australia we need to have a more aggressive attitude on changing the costs elements of the business model to protect our members and ensure the long term survival and success of our local asset managers.

Reasons & effects

1. Flat dollar fee, rather than a % of assets, sharpens the focus for asset manager, provider and member
2. Better matches effort and work done with fair wages for that work done.
3. Is much more transparent to all concerned.
4. Reduces escalation and volatility of fees with market volatility.
5. In effect, with flat dollar fees, the brakes on fees are on by default, not having to be continuously applied and released.
6. Negotiations become negotiations on increasing fees not reducing them, which increases the likelihood of costs being constrained.

3.6.4 Asset allocation and access

Functional area: Investments

Primary Issue: Issue 1 – Costs are too high
Secondary Issue: Issue 8 – Limited product and service range for retirement income

Analysis

Asset allocation for market linked Retirement Income products including account based pensions will progressively become less aggressive as age increases, but generally should retain pre retirement levels of investment risk and related return until around age 75 given male and female life expectancies at 75 are higher than ever – 11.4 years for males and 13.6 years for females (ALT2007-09)[18]. Over all retirement ages combined, account based investment costs should be less than the equivalent in accumulation as more conservative investments are less expensive to manage. This should cause a small reduction in retirement income costs as a % of FUM as the retirement income industry grows relative to super in total as illustrated in section 1.

There is a strong need for alternative income products which are less expensive than the guaranteed products like fixed and variable annuities but are less risky than account based pensions fully exposed to the investment growth markets. These may be simply more tightly constructed and managed portfolios which combine steady cash flow income with solid rather than spectacular growth and longer term horizons.

RI cost reduction action:

1. Access to new investment. Expertise and experience is essential to enabling super investing in alternative assets e.g. private equity and infrastructure so increasing scale is important e.g. via merger and acquisition.
2. Greater use of providers' own platform or SMSF's own direct portfolio construction focussing on longer term recurrent income streams using relatively high franked dividend income, government securities, corporate bonds and other fixed interest. Focus on the income. An alternative to other packaged income streams like term annuities.

3. SMSFs and providers can use these packaged portfolios. For example one form could be based around finding tax effective dividend income e.g. Russell's High Dividend Australian Shares ETFs.
4. Avail of Govt investments that match assets and liabilities and reduce risk in inflation, long term duration and longevity - when available – see Govt support needed in Issue 8.

Reasons & effects
1. Provides retires with what they ultimately need – income at low cost.
2. Risk reduction is expensive – not surprising given market expectations of an equity risk premium at up to 6% p.a. historically and the volatility of equity prices that prevents the level income streams many retirees seek.
3. Security of at least some income is important to retirees especially in later years.

3.6.5 Administration – Middle Office – Product complexity

Functional area: Administration –Middle Office

Primary Issue: Issue 2 – Lack of transparency around costs

Analysis
Structured products as investment offerings can be very complicated and risks not understood. Guaranteed income or return products are a subset of this.
In the retirement income context some such income products (variable annuities) can also be guaranteed for life, which meet a core need of retirees and introduces the additional complexity for the provider of insuring the mortality / survival risk.
To most retirees and many advisors these are very difficult to compare and assess the relative cost of the investment and the life guarantees.
FOFA recommendations are driving transparency but aspects are being strongly contested by the sections of the industry with most to lose.

RI cost reduction action:
1. Better disclosure of the charges for the guarantee and residual life insurance / longevity components where applicable, in a standard format so that advisors and retirees can compare like with like.
2. More education on the nature of these products.
3. Implement FOFA recommendations in full to avoid conflicts of interest and provide extra focus on what services being delivered for agreed fees.
4. Implement the proposed annual member "opt-in" process so that services being paid for are understood by and an active choice for members.
5. Industry to work on plain English explanations of the fees explicit and implicit in products and their delivery including platform use – but the complication level is high which makes this a difficult process.

3.6.6 Embracing SMSFs

Functional area: Administration - Front Office

Key Issue: Issue 5 – Rise of the SMSF

Analysis
Adding to the analysis in section 3.4.5 *Issue 5 - Rise of the SMSF*, SMSFs have been one of the biggest trends in super in recent years. At 31 December 2010, APRA reported[19] self-managed superannuation funds held the largest proportion of superannuation assets accounting for $421m being 32.0% of the total superannuation assets of $1.32 trillion. Industry funds and retail wealth management companies need to offer those services to meet SMSFs need at low costs, efficiently and effectively or lose out on the market.

The SMSF administration scene is fragmented and offers potential for scale related costs reductions. The administration burden could in future be taken by the big superannuation funds and wealth management companies rather than the small niche SMSF administrators if they develop that capability. Some industry funds are competitive on the investment side already in attracting SMSFs money and they too could expand into SMSF administration and support. This would provide good capture and retention with enhanced scope for future sales of retirement income products.
SMSF Trustee members are the least likely to forget that "it's their money", when it comes to pricing services because of the high control, visibility and interest levels in their funds.

RI cost reduction action:

1. Funds to provide specialist SMSF services as an adjunct to what they do for their own members. These services should in the medium term cover administration, product, and investment.
2. Great competitive tension for the industry. Spreads provider's costs over wider base.
3. Diversity of product with government support critical to having an open competitive lower cost market, which SMSFs as independent buyers of products and services, contribute greatly to driving.
4. Consolidation and growth of existing SMS administration and service specialists as they increase scale and get the benefit of that in productivity and cost efficiencies.

4 Retirement Income costs – targeting a minimum cost framework

"It is better to have a permanent income than to be fascinating." - *Oscar Wilde*

4.1 Principles for a target Retirement Income minimal cost framework

Principles to be adopted to achieve a minimal cost framework to members for retirement income are:

1. Must have a primary focus on reducing dollar costs. These will then flow through to lower costs as a % of funds under management.

   This requires a fundamental cultural and attitudinal change across the industry. The current focus on fees and charges as a percentage of assets under management creates a damaging cycle of escalating fees, analogous to the wages indexed to inflation breakouts of the late 1970s.

2. The underlying superannuation (accumulation) industry must in itself be best practice in each of the functional areas affecting costs:
   a. Administration
   b. Investment management
   c. Advice.

3. The Retirement Income sub-industry must in itself be:
   a. Competitive
   b. Transparent
   c. Have a wide range of product solutions to meet retirees' need
   d. Have supportive government policies, retirement income related legislation and related regulatory regime.

4. Must focus on increasing value for money as well as reducing costs - thus encouraging service(s), including product diversity, to members to be improved.

5. Must recognise the specific specialist needs of retirees as a group distinct from members in the accumulation phase, and within the retiree group recognise the heterogeneity and different needs and attainable goals emphasis across sub-population segments – by age group, socio economic group/wealth level, and super fund type, including :
   a. Those approaching retirement (range 50 to 65 say)
   b. Those in the first phase of retirement. (range 60 to 75 say)
   c. Those retired for some time (range 75 to 85 say)
   d. The long term retired (85+).

6. A need to attack multiple cost issues in parallel

4.2 Implementation of a target Retirement Income minimal cost framework

Table 4.1 below identifies the lowest cost options across all functional areas. It is to be interpreted as a target for reducing costs and illustrates the extent to which it would be possible to reduce costs. I recognise many providers' business models, in particular around level of service and choice to members, will give rise to higher, but still reasonable levels of costs, because the benefits and services they provide cost more, and are worth more to their members. However, the promise of better value and better needed services should not be used as an excuse for avoiding the harder option of reducing costs further. Cost reduction

decisions invariably return later as a greater challenge. Providers, and their skilled employees, including marketing and sales experts, and actuaries, in my experience, can have a tendency to overestimate the value of bells and whistles in products and services to members relative to the loss of value and higher costs incurred by the provider and borne by members in due course, in providing them.

The key to any provider, aiming to reduce costs is to seriously consider each of the proposed minimal cost elements and be honest with oneself as to the real outcomes for the provider and the member.

Planning and implementing a cost reduction project is hard work and requires experience and expertise on multiple fronts including change management, business re-engineering and project management quite apart from the financial cost benefits of the changes.

Bearing in mind those multiple elements, consider:

Cost functional area	*Minimisation action*	*Reasons & effects*
Administration – Back office – Processing, IT&T	Mirror Stronger SuperStream recommendations into retirement income – e-commerce, TFN.	Efficiency from automation and no exceptions thus avoiding manual processing/intervention.
	Charge admin fees as dollar.	Keeps sharper focus on costs for provider and member.
	Share cost of building support systems including for new products & advice.	Lower development cost per member.
	Have a strong member retentions program.	Build / retain scale – lower cost per member
Administration – Middle office - Product development Management Strategy	Keep products as simple as possible, but: Badge or share development of guaranteed and longevity products. Pursue mergers & acquisitions	Increased complexity increases development, sales, administration and servicing costs. Product diversity critical to meet needs & member retention Build scale & volume – lower costs per member & spread product diversity costs
Administration – Front office Distribution - Platforms	If platforms a key part of business model, aim for a single all embracing platform. If not, avoid them. Replicate only core elements re investment on choice in own fund.	Just one system to maintain. Get scale benefits – lower cost per member covered. Provide core benefits without cost and complication of platform delivery.
Member service	Open direct channels to people with higher net worth/balances eg SMSFs	Build and retain scale enabling lower costs per member.

Table 4.1 Minimal Cost Framework for Retirement Incomes (RI) - Administration

Cost functional area	*Minimisation action*	*Reasons & effects*
Investment - Investment management	Use passive / indexed investments as core	Market returns at low cost
	Use investment manager(s) that charge base dollar fees - not as a % of FUM.	Truer fee for service. Avoids escalation of fees with member account and investment markets growth. Enforces fee reductions as % of FUM over time.
Investment - Asset allocation & Investment Mgt	Greater use of own portfolio construction focussing on longer term recurrent income streams.	Provides retirees with what they ultimately need – income at low cost.
	When available use Govt investments that match assets and liabilities and reduce risk in inflation, long term duration and longevity.	Lower provider costs as risk reduction is very expensive given long term nature of market, inflation and longevity risks. Security of income important to retirees.
Advice	Provide access for own members to basic advice based on segment advice templates at clearly set out fixed dollar costs.	Member knows cost so can make value decision on use. No surprises. Reduces chance of misselling.

Table 4.2 Minimal Cost Framework for Retirement Incomes (RI) – Investment & Advice

5 Conclusions and recommendations

"To make a million, start with $900,000." - *Morton Shulman.*

5.1 Introduction

To echo Morton Shulman's sentiments, there are no instant short cuts or easy solutions with reducing retirement income costs, just as in successful investing in the long term.

I am also acutely aware that is easier to pontificate on cost reduction than it is to execute well on implementing a cost reduction program.

My conclusions and recommendations are based on the data and observations set out in sections 1 and 2, the issues analysis in section 3 and reflect the best practice retirement income costs reduction framework which flowed from that analysis.

As noted in section 1.3 publicly available data on retirement income costs is very limited and the cost base will change significantly going forward which has limited the extent of analysis possible. I have formed opinions and reached conclusions and recommendations based on those opinions following the analysis.

5.2 Conclusions - general

1. There is significant scope for retirement income cost reductions in administration, investment and advice

2. Best to attack costs on all fronts

3. Focussed, efficient, effective execution of retirement income cost reduction ideas and implementation projects is critical

4. The costs war is never over.

Strong sound strategy, widely based with tight focus on each cost reduction idea, can lead to battle wins and over time, with discipline, can accumulate to winning the war, for a time.

5.3 Conclusions & Recommendations for reducing Retirement Income costs

1. Stronger Super and Future of Financial Advice changes set a good base for reducing superannuation accumulation and retirement income costs:
   - needs to be implemented as soon as possible
   - needs to be implemented well and needs to achieve its objectives

2. Providers should pursue scale via mergers & acquisitions

3. Funds should passively invest a greater portion of their assets
   - target 50% of portfolios in liquid, well traded sectors

4. The Australian Government needs to implement key Henry Review and Institute of Actuaries of Australia recommendations to support retirement income product innovation by the private sector:
   - encouraging a diverse annuity market including deferred annuities
   - issuing or enabling long term suitable matching investments – inflation linked, ultra long term, longevity and infrastructure

This will enable competitive, value products at higher volumes, less cost and less risk

5. Investment costs for retirement income could also be reduced by setting base contracts in dollar not % of FUM

6. The continued growth of SMSFs will increase the competitive friction around retirement income provision and hence constrain retirement income costs
   - demand for guaranteed and longevity products
   - investment & portfolio construction securities and products

7. Low cost flat dollar fee effective advice options for pre and post retirees will emerge as advice models are road tested and refined

5.4 Acknowledgement

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