The potential impact of investment restrictions on fund earning rates

The Association of Superannuation Funds of Australia's submission to the productivity Commission inquiry into certain superannuation legislation contained the following statement:

> Acting within broad principles of having to construct an investment strategy, trustees are free to seek long-term returns that are in the best interests of members. This allows superannuation fund trustees in Australia to better capture the full benefits of the market. This has allowed Australian superannuation funds to returned far better long term returns than funds in many countries with tighter restrictions on investments

Information in support of the above statement is contained in the following documents:

> OECD Private Pensions Series (Paper No. 1) - *Private Pension Systems and Policy issues.*
>
> World Bank policy research report – *Averting the old age crisis: policies to protect the old and promote growth.*
>
> Reserve Bank of Australia Occasional Paper No 8 Australian Economic Statistics June 1996
>
> In Tech Growth funds Performance Survey, 30 April 2001

The proposition that returns to equity will exceed the returns to debt over the medium to long term is supported by both a range of commentators and by authoritative data. Superannuation funds will generally hold a proportion of their funds in debt assets in order to tailor the risk characteristics of the fund and to provide greater liquidity. However, government restrictions on investments, particularly any requirement to hold government securities and/or not to have overseas investments will depress fund earnings.

The World Bank has concluded that, as a general rule, there were fewer investment restrictions imposed in developed countries and that:

> Pension funds have taken advantage of this regulatory freedom to place a larger share of their portfolios in equity investments, yielding a higher rate of return than more restricted financial institutions can achieve. In developing countries, the limits on equity investments are generally stricter.

The paper goes on to state that:

> Most countries, especially developing countries, restrict the foreign investments of their pension funds. Foreign investment entails an exchange rate risk as well as ordinary stock and bond market risks. It may thus seem to increase risk. But

> it actually decreases risk because markets are not perfectly correlated across countries. Comparisons of returns to actual portfolios, hypothetical domestic portfolios diversified between equities and bonds, and foreign portfolios in OECD countries for 1970-90 show that a higher share in equities raises both rates of return and risks, whereas international diversification generally reduces risk, sometimes at the expense of yield. Opening the door to international investments of pension funds would seem to be warranted, to diversify and thereby diminish risk.

The following table, drawn from the OECD paper, lists countries with mandatory pension systems and the maximum portfolio percentage limit on various asset types as at December 1998

	Argentina	Chile	Bolivia	Peru	Colombia	Mexico	Uruguay	El Salvador
Government Securities	50	50	Min $180m	40	50	10	Min 75 Max 85	100
Corporate bonds	40	45	30-45	49	20	35	25	30
Financial Inst. Sec/deposits	28	50	50	30	50	10	30	40
Shares	35	37	20-40	35	30	0	25	5
Investment companies/ mutual funds	14	10	5–15	15	5	0	0	0
Foreign securities	10	13	10–50	10	10	0	0	0
Hedging instruments	2	9	0–5	10	0	0	0	0

The effect of the above type of investment restrictions is given by the World Bank in two examples:

> "(P)rescribed investments" in South Africa earned a negative real return of 3.6 percent in the 1970's and negative 0.9 percent in the 1980's while the real return to equities was strongly positive – 13.2 percent and 5.6 percent respectively.
>
> Special investment requirements for pension funds for state and local workers in the United States also decreased yield.

The table on the following page compares the 10 year average rate of return for Australian Commonwealth Government Bonds, ordinary shares, 3 month bank bills and a typical balanced superannuation fund during the period 1979- and 1995. The figures are drawn from the Reserve bank occasional paper. This period 1979 – 1995 was chosen as 1979 is the first year the average is available for all four investments types and 1995 was the latest available year at the time the paper was written. The 10 year rate refers to the average (compound) increase in the relevant accumulation index over the 10 years ending in the year shown. The comparison of ten year rates is considered appropriate given the long term nature of superannuation investments.

Long Term Returns on Financial Assets and Superannuation

June	Commonwealth Government Bonds	Ordinary shares	3 month bank bills	Typical Balanced Superannuation Fund
1979	6.2	5.2	8.7	6.8
1980	6.3	10.7	9.2	10.5
1981	6.3	13.6	9.8	12.0
1982	5.4	6.9	10.8	9.6
1983	7.4	10.5	11.9	12.2
1984	9.5	15.2	12.2	15.4
1985	10.4	18.8	12.3	16.7
1986	11.3	20.0	13.2	17.7
1987	11.9	24.7	13.9	20.1
1988	11.9	22.1	14.1	18.5
1989	12.0	19.8	14.6	18.1
1990	13.2	14.4	15.4	15.7
1991	15.2	12.8	15.5	14.9
1992	17.8	18.3	14.7	16.4
1993	17.0	15.9	13.5	14.9
1994	14.3	16.7	12.9	14.4
1995	14.0	13.5	12.2	13.0

The In Tech Survey of 30 April 2001 contains the following seven-years rates of return for similar categories:

April	Australian Bonds	Australian Equities	Cash	Average Growth Fund
2001	9.1	11.2	6.2	9.8

The ability of the typical Australian balanced superannuation fund to regularly outperform both bonds and bank bills shows the potential benefit for superannuation fund members of the Australian approach to regulating superannuation fund investments. While there will be some periods (usually when there is high inflation and high nominal interest rates and depressed stockmarket prices) when the returns to debt outweigh those for equity, this will not generally be the rule. However, where these fluctuations do occur, superannuation funds acting without restrictions on investments can react to, and take advantage of, prevailing conditions. The strength of the trustee system is that investments will be made by funds on the basis of prospective returns and risks rather than to pursue a collateral purpose of government. The evidence available in both Australia and overseas is that government mandated investments almost never will be to the advantage of fund members.

The number of superannuation funds, their size distribution and manner of supervision

1. Sources of data on number of funds

While one would think that it should be relatively straightforward for the regulator to count the number of regulated superannuation funds, there appears to be considerable confusion about the number and nature of superannuation funds operating in Australia. Unfortunately, much of this confusion has come from conflicting information released by the Australian Prudential Regulation Authority (APRA), the regulator of funds with five or more members and of some thousands of funds with less than five members. There also is uncertainty due to difficulties and delays in establishing whether some thousands of small funds have or will become Self Managed Funds (SMFs) under the supervision of the Australian Taxation Office (ATO), or remain under the jurisdiction of APRA as Small APRA Funds (SAFs).

Recent APRA publications and statements provide widely different estimates for ostensibly similar categories of funds. For instance, on 11 May 2001 in evidence to the House of Representatives Standing Committee on Economics, Finance and Public Administration, a board member of APRA, Ian Macfarlane, indicated concern about the stability and prudential supervision of what he claimed to be about 10,000 intermediate sized funds which were self managed and with more than five members each (Hansard, EFPA 85).

Subsequent to that hearing, senior APRA officials indicated to ASFA on 14 May 2001 that the number of funds with between five and fifteen members and less than $1 million in assets was between 3,000 and 4,000. APRA has concerns in regard to some of these funds relating to their investment strategies, particularly limitations in regard to asset diversification and liquidity.

However, other APRA documents indicate much lower numbers of funds in total, and by implication in the size range that became the subject of the public comments. The publication *APRA Superannuation Trends – December quarter 2000* estimates the total number of corporate, industry, public sector and retail funds with at least five members at 2,312, with Small Funds (with less than five members) at 216,907. The APRA Annual Report 2000 at page 14 indicates that at June 2000 there were 130 superannuation entities supervised by its Diversified Institutions Division (which deals with entities active in more than one prudentially supervised activity). A further 2,800 superannuation entities were reported as being supervised by its Specialised Institutions Division (which deals with entities which specialise in just one field, such as a superannuation fund or credit union). The Report also estimated that a further 8,500 funds with fewer than five members stayed with APRA as SAFs.

On the face of it, reconciling these numbers appears to be a difficult task. It may be more useful to consider the limitations of the various estimates and the context in which they are put forward in order to explain the potential bias in each estimate, and the inconsistencies between them rather than settle on a specified estimate as the best estimate.

For instance, ASFA understands that some caution is required in the use of the number of funds data contained in the APRA quarterly Superannuation Trends publication. That publication contains very representative data based on the quarterly survey of the largest 370 superannuation funds. However, that survey can provide little or no information on changes in the population of the balance of smaller funds, with the estimate of corporate fund numbers apparently a rather dated projection rather than any actual count of such funds. There also is the problem of funds self identifying the category in which they fall. Whether a fund 1s a public sector fund, industry fund or corporate fund generally is not a matter of concern to the regulator, and it is not unusual for at least some funds to change the label they want to be attached. This may come with a change in the ultimate owner of the dominant employer sponsor, or with changes in the marketing activities of the fund.

More accurate estimates of the number of funds are provided by annual return information and levy payments by funds and other superannuation entities. While this information is not publicly released in a general way, it is made available to ASFA as part of the annual consultation in regard to levies for the forthcoming financial year.

2. The number of superannuation funds and their distribution by asset size and taxable income

Table 1 provides details from 1996 to 2000 of the number of superannuation entities paying the APRA levy and their size distribution by asset level.

Table 1: Superannuation entities by level of assets

Asset Range ($)	1996	1998	2000
<1m	2,562	1,826	1,956
1-5m	645	1,248	963
5-10m	511	506	362
10-20m	363	370	338
20-50m	304	342	330
50-100m	129	146	151
100-250m	105	145	163
250-500m	42	67	72
500-1,000m	25	45	66
1-5b	20	44	60
5-10b	2	4	6
10-20b			2
20b+			
Total	**4,718**	**4,743**	**4,469**

Source: Assorted APRA Discussion Papers on proposed levies.

These estimates are prepared for levy discussion papers on the basis of annual returns received by January to March following the completion of the relevant financial year. APRA has indicated that generally there are up to another 500 or so returns still to be received at that stage, mostly from small corporate funds. There is nothing to suggest that several thousand are still outstanding at that stage, with actual levy collections consistent with the number of entities and their size distribution that were specified in the discussion papers.

While there may be some uncertainty around the edges due to labelling problems, it remains clear that the bulk of the superannuation entities supervised by APRA are corporate funds, that is superannuation funds with one employer sponsor. These are funds, many of which are relatively longstanding in nature, which have been set up for the benefit of the employees of one company or group of associated companies.

Also included in the above figures are public sector, retail and industry funds. There are around 100 industry funds, around 100 public sector funds (not all of which are supervised by APRA or pay a levy), and up to 300 retail funds.

The APRA figures on superannuation entities also are likely to include a sizeable number of single member Approved Deposit Funds, along with the much larger in terms of assets Pooled Superannuation Trusts (PSTs). While there are some major ADFs in operation, in the early 1990s it was common to set up single person ADFs in order to rollover superannuation monies on termination of employment or retirement. The development of public offer retail and industry funds since then has largely negated the need for such a device. However, once established there is some inertia in winding them down. While not offering the convenience or low cost of some alternatives they do provide greater flexibility for their single members. However, there is evidence that a proportion have in effect be abandoned in that no administration is undertaken on a systematic basis, with no submission of annual returns to APRA and/or the ATO.

PSTs are essentially an investment conduit available only for investments by superannuation funds. They have no direct dealings with fund members but because of their importance to the prudential supervision of superannuation funds they are under the supervision of APRA.

Table 2 provides details of the number of ADFs and Pooled Superannuation Trusts lodging tax returns. It is possible that not all single member ADFs lodged tax returns and/or APRA annual returns, although the incidence of non-reporting is unlikely to change markedly between years.

Table 2: Approved Deposit Funds and Pooled Superannuation Trusts

	1995-96	**1997-98**	**1998-99**
ADF with tax paid less than $4,000	1,463	655	455
ADF with tax of more than $4,000	47	17	23
Total ADFs	1,618	655	455
Total PSTs	135	135	113

Source: ATO Taxation Statistics, various years

While admittedly there is some uncertainty, these figures taken together with the number of the total entities regulated suggest that the number of corporate funds has fallen to around 3,300, but has not moved markedly over the last five years or so. Some funds have closed, offset by the establishment of some new corporate funds. That said, there are indications of a not insignificant number of closures and consolidations of corporate funds in the last year or so.

This is indicated by both ATO and APRA data (Tables 3 and 4). However, there is a reasonable amount of noise in the figures and some inconsistencies between sources, particularly in regard to the number of SAFs and Self Managed Funds. Smaller funds, including some small corporate funds, have not always been diligent in their returns to the regulator and the ATO. Some funds are effectively closed, but they fail to tell the regulator and/or do not undertake the final steps necessary for formal closure. ASFA appreciates the difficulty in maintaining contact with a population of some thousands of funds when changes of address and/or status are not always communicated. When ASFA mailed out material on the GST and superannuation funds making use of an APRA supplied list of non-excluded funds, a substantial number of the items were returned “addressee unknown”.

The estimates of the number of small funds also can include a count of funds for which a superannuation fund number was applied for but which were not actually established. Some accountants kept a stock of excluded funds in their pending tray at the end of each financial year.

Once allowance is made for the decline in the number of single person ADFs, there is little or no decline apparent in the derived estimate of the number of small corporate funds, and a drop of around 120 or 7% in the number of superannuation funds with more than $5 million in assets (Table 4). As well, this fall in the number of larger funds merely returns the number of such funds to the level that applied five years ago. Similarly, there has not been much variation in the number of superannuation funds with taxable income of over $100,000, and not much movement in the number with tax paid of over $50,000 (Table 3).

There was a fall of around 185 in the number of funds with assets of between $5 million and $50 million between 1998 and 2000 (Table 1). Over the same period the number of funds with assets in excess of $1 billion increased by nearly 50% from 48 to 68. While some of this would have come from investment earnings and contributions from existing members, these larger funds are likely to have been the beneficiaries of the closure of the 185 smaller, but still substantially sized, funds in terms of assets and members. While the bulk of those smaller funds are likely to have been corporate funds, there also were closures or consolidations of some relatively small retail and industry funds in that period.

Table 3: Number of superannuation funds by level of tax paid

	1995-96	1997-98	1998-99
Tax of less than $50,000	121,361	160,328	173,292
Tax of more than $50,000	2,270	1,817	1,812
Tax paid more than $100,000	1,144	1,138	1,149
Total funds lodging a tax return	126,631	162,145	175,104
Number of excluded funds (APRA data)	121,711	144,468	197,123

Source: ATO Taxation Statistics, various years

Table 4: Number of superannuation entities by level of assets(a)

	1996	1998	2000
Assets less than $5 million	3,207	3,074	2,919
Assets more than $5 million	1,511	1,669	1,550
Total superannuation entities	4,718	4,743	4,469

Source: APRA supervisory levy discussion papers, various years

3. Implications of the data for the sector and for prudential supervision

Whither corporate funds?

The various official APRA and ATO data do not provide much support for the contention that corporate funds have been closing at a great rate. A fall in the number of corporate funds from 3,500 to 3,300 over the last few years could not be regarded as a collapse in their numbers.

Many very small corporate funds (with assets less than $1 million and fewer than 20 but more than 5 members) remain. Such funds may not always be diligent in all of their activities or offer well diversified investment portfolios, but equally they are not usually organised enough to close themselves down. As well, to the extent that their investment portfolio is in illiquid assets such as property it may be difficult for them to close down. While the undiversified investment portfolios of many of these funds may have been less than optimal during the 1990s, now may not be the best time for them to switch into more diversified portfolios with higher weightings of Australian and international equities given the current stage of the economic cycle.

Large corporate funds are at the other end of the spectrum, with their continuing existence often a product of informed choice by company management rather than inertia. They generally remain in business because they have the critical mass and expertise to provide a cost effective mechanism for superannuation coverage, and enable large companies to provide what is perceived to be a valuable benefit by their employees.

Mid-range corporate funds (with more than 20 members but less than, say, 200) are perhaps the ones most likely at present to close down or at least consider closure. They are large enough to be able to consider a rational transition process, but are of a size which does not support any reasonable economies of scale while diverting the attention of company management from core business. As well, actual or perceived increases in regulatory burdens associated with foreshadowed licensing and disclosure arrangements are having an impact on the management of smaller corporate funds and their employer sponsors. As well, where one employer is responsible for a number of funds because of past corporate takeovers and/or separate schemes for executives and staff employees, there are understandable pressures to consolidate into one scheme.

However, it is likely that providers of public offer superannuation products will continue to claim or predict a collapse in the number of corporate funds regardless of how many are actually going down that path. This may well be the perception of such providers as they naturally enough will have dealings with funds that are most likely to close down. Their anecdotal impressions are driven by the funds they know have closed down, rather than by any knowledge of the several thousand that have not. There also may be elements of self-fulfilling predictions, with a desired marketing outcome being increasingly perceived to be the way of the future.

How many small corporate funds are there, and are they a potential source of risk in the superannuation system?

Table 1 does not provide any evidence that there were or are more than 3,000 corporate superannuation funds with assets of less than $1 million and puts into question APRA's statement that so many funds (and members) are at potential risk. Once allowance is made for single member ADFs and very small or near defunct other superannuation entities, the number of corporate superannuation funds paying levies and having assets less than $1 million appears to be under 1,500. Even if all of the estimated 500 late returns were from small corporate funds, this would not raise the number above 2,000. As well, many of these funds have more members than the band of 5 to 15 members specified by APRA as the type of fund for which they have some concerns.

This calculation is confirmed by data provided by APRA in regard to corporate funds as at June 1998 on the basis of returns lodged as at April 1999. Table 5 provides details.

Table 5: Assets and membership of superannuation funds with assets less than $1 million as at June 1998

Asset level	No. of funds	Average assets per fund	Total assets	Members per fund
Less than $500,000	819	$196,000	$160 million	17
$501,000 to $600,000	89	$550,000	$49 million	23
$601,000 to $700,000	69	$654,000	$45 million	20
$701,000 to $800,000	69	$744,000	$51 million	128
$801,000 to $900,000	81	$852,000	$69 million	23
$901,000 to $1 million	59	$948,000	$56 million	30
Total	1229	$365,000	$448 million	27

Source: APRA communication to ASFA dated 9 April 1999

While numerically a large proportion of APRA supervised funds (putting SAFs to one side), the aggregate assets and member accounts involved in these funds is very low compared to the system as a whole. The assets of such funds formed only 0.1% of system assets as at June 1998, and accounted for only 0.02% of member accounts. As well, the management and investment of these funds is generally separate from all other funds. The existence of deficiencies in one fund is not likely to lead to problems in any other fund.

There is of course a strong case for action by the regulator to minimise any behaviours in small funds which would adversely impact on their members. However, it would be unfortunate if pursuit of the numerous small funds was to compromise prudential supervision of medium to large funds and the activities of Approved Trustees responsible for the management of numerous SAFs and public offer funds with medium to large memberships and assets.

The problems of the recent CNAL and EPAS cases, while largely the product of the directors involved in those entities, indicate the dangers of the regulator "not keeping the eye on the ball". A true risk based regulator needs to make assessments of both the probability of deficiencies in controls and management, and the potential damage to members. With the benefit of hindsight it is clear that greater attention should have been given by APRA to Approved Trustees responsible for small to medium sized public offer funds and SAFs.