

PRODUCTIVITY COMMISSION INQUIRY – SUPERANNUATION

**GRANULAR DATA AS A CATALYST TO PROMPT OPERATIONAL
EFFICIENCY IMPROVEMENTS**

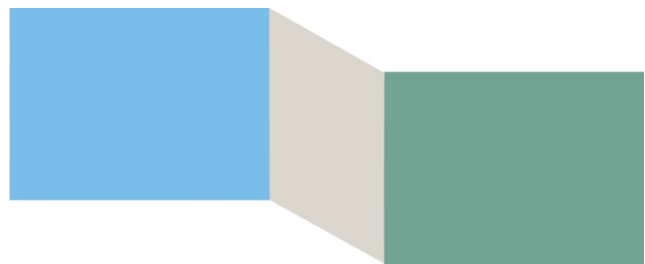
18 April 2016

Authors:

Richard McManus

Sam Bourke

Alex Guyer



Introduction

Despite strong intentions from superannuation funds to deliver value to customers/ members, we are confident there are opportunities to further enhance value through improved operational efficiency. We argue that in order for the funds themselves to set and achieve significant, but realistic, cost saving targets an industry-wide and holistic understanding of cost is required.

A well informed industry, and by extension the funds operating within it, will be able to identify and implement operational improvements better than they currently can. Further, we believe a greater urgency is required in demonstrating that operational efficiency improvements can lead to better value for customers/ members. We are concerned that a multitude of factors in the competitive environment (e.g. account consolidation, capability enhancements and heightened marketing spend) for superannuation funds may result in increasing rather than decreasing costs. It is therefore critical that the industry be proactive in cost containment in order to maximise the value it can deliver to customers/ members.

Overall Thesis

Granular information can commute the desire for cost discipline into action

Superannuation funds, whether retail or industry, undoubtedly have the desire for cost discipline in their operations. Understandably, however, some may cast doubt on this assertion claiming the achieved outturn is not consistent with it. But we argue that management lack the granular normalised cost data to turn their desire for cost discipline into proactive industry-wide action.

The major shortfall we have identified which prevents the desire for cost-discipline from being turned into demonstrably cost-effective operating models is the lack of necessary comparable cost data. We believe if and when this information shortfall is addressed that management, both self-motivated and prompted (e.g. peer group pressure, Board requirements, regulatory scrutiny, customer / member expectations), will address evident cost inefficiencies with alacrity.

Well-directed cost discipline will yield enhanced customer/member value

Reliable, scrutinised data will help ensure the accountability of industry participants to optimise the system in which they are operating. We believe a thorough assessment and understanding of fund level operational efficiency is an essential element in determining the prospective benefits the entire superannuation industry can achieve. The lack of sufficient data regarding operational efficiency and the benefits accruing from this means that industry participants lack the benefits-driven incentive to really contain costs. Specifically we judge:

1. Individual funds do not have sufficient knowledge of other participants to effectively determine the most cost-efficient operating models achievable;
2. There is a poor understanding of the linkage between cost efficiency and customer/ member value; and

3. Even engaged stakeholders (e.g. employers, employees) lack the information wherewithal to effectively scrutinise operations and the price charged to customers/ members.

Irrespective of the cost efficiency of individual superannuation funds, we believe there remains significant scope to improve operational efficiency in the industry overall. Making the link between cost efficiency and customer/ member benefits is crucial to promote more widespread cost discipline. It will prompt action by industry participants in light of competitive expectations grounded in data. We believe laying this foundation is a critical element in the pursuit of customer/ member value and better retirement outcomes.

Delivery of enhanced benefits will promote market discipline as preferable to prescriptive regulation

For an industry of such critical importance to Australians, the economy and the Government, more robust data and information availability to spur competition, accountability and transparency of operations should be a pre-requisite. Demonstrating that improvements in operational efficiency translate into lower costs for consumers and better retirement outcomes will actually foster the increased customer/ member engagement about which there is so much talk. And this in turn will precipitate informed choice on the part of customers/ members and a situation where those delivering value will grow at the expense of those that are found wanting. The resulting market discipline will provide a strong incentive for individual funds to focus on the cost effective delivery of value.

We believe the objective of increasing the efficiency of the entire superannuation system can be best achieved by incentivising all funds to increase their operational efficiency. Indeed, we judge it will ultimately be initiatives 'from the ground up' that deliver lasting improvements in the sector rather than regular and considerable regulatory changes. Despite good intentions, strong arguments contend that these regular changes have hindered and slowed improvements in operational efficiency throughout the sector. Since there can be no single *a priori* preferred superannuation operating model as different customers/ members will gravitate to different superannuation value propositions it seems unwise to rely upon prescriptive regulation if one can, as an alternative, foster market discipline. We believe it is in fact necessary to better involve operational efficiency considerations whilst determining future regulatory changes as regulatory micro-management could actually have a significant deleterious impact on market participant cost efficiency.

The challenge for superannuation funds and the system

Realising significant industry-wide benefits

Improved operational efficiency in the industry will directly result from the aggregate improvements of individual superannuation funds. It seems clear that there are significant potential improvements in operational efficiency which can result from:

1. Eliminating past costs which are now unnecessary: consumer, digital and technology developments will champion the new delivery of many services a superannuation fund would

typically provide and indeed make some redundant. For instance the downsizing of contact centres and field teams is likely as digital platforms offer methods to effectively handle increasing volumes of customer/ member contact.

2. Reengineering some costs: to enhance internal cost structures and achieve greater productivity through the redesign of core processes. For example, substituting manual processes with IT-enabled ones.
3. Improving operational economics: realising economies of scale and scope will increase in significance as the industry continues to grow. For instance, these can be achieved through bringing activities in-house or bolstering negotiation with outsourced providers.

Building and sustaining momentum

Despite knowing significant improvement is possible it is far from clear that these improvements will actually accrue. Numerous factors are emerging that will place strain on traditional revenue models, resulting in previously attainable margins being placed out of reach. Further compounding this, relative costs may foreseeably increase for funds that struggle to acquire and retain customers/ members over the coming years.

It is anticipated that the competitive landscape for funds will intensify as industry and retail funds begin to compete more directly. The superannuation industry will move to enhance customer/ member experiences with significant investments across digital and advice capabilities, and a stronger focus on the provision of retirement income. Furthermore, as the population ages, engagement in the industry will continue to increase and – of concern for many funds – account consolidation throughout the industry will steadily rise.

With regard to investment operations it is widely anticipated that a period characterised by lower returns and increased volatility is upon us. Many within the industry are beginning to look to and move toward more cost-efficient investment management models (e.g. in-house capabilities, enhanced negotiations with external providers). The challenging environment will necessitate significant investment to ensure a strong capability in this area and astute trade-offs between costs and potentially higher gross returns (for instance placing more assets in indexed funds).

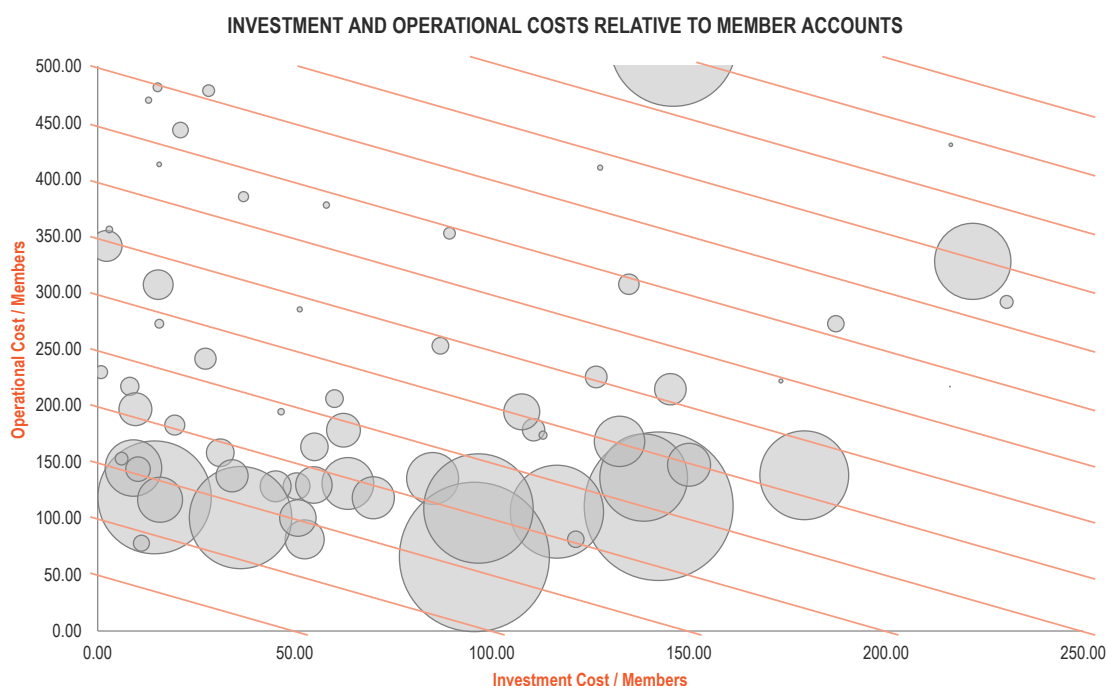
This growing number of factors necessitating increased investment in capabilities and straining industry revenues threatens the industry's ability to demonstrate better value can be delivered to customers/ members. As a result we believe a greater degree of urgency is required in regard to demonstrating that value transfer, through enhanced operational efficiencies, can in fact be made and that actions are beginning to be taken.

The operational improvements will be hard-won through astute and well-informed management intervention. Without this intervention the cost impost might actually increase as account consolidation forces funds to amortise semi-fixed operational costs across fewer customers/ members at the same time as investment to enhance capabilities is picking up. This highlights the need for the industry to have the capability to better identify, address and implement cost and operational efficiency improvements.

Leveraging market discipline

Funds will be navigating a challenging period of increased competition for the acquisition and retention of customers albeit in an environment characterised by disengagement for the near future. However, the minority at the margin who are better-informed will nevertheless be courted by funds keen to grow in a more tightly contested environment. And the quest to woo these floating marginal customers will actually precipitate a rapid increase in market discipline. This will particularly be the case when superior net returns are shown to be closely linked to lower costs.

We think it is significant that the industry has struggled to demonstrate scale benefits are significantly contributing to operational efficiencies and enhancing the value provided to customers/ members. The snapshot of the industry below from publicly available APRA data helps show a lack of correlation between scale and cost/ member. We would expect larger funds to demonstrate better costs per member than the smaller; however, as can be seen, many smaller funds are outperforming the larger. We think it is therefore crucial that small and large funds alike are incentivised to strive for cost efficiency rather than assuming this will necessarily result from prescriptive regulation mandating increased fund scale.



Size of bubble represents relative size of membership, figures in \$AUD

Diagonal lines represent iso-cost per member

Source: APRA 2016

Note: we are aware of inconsistencies in the reporting of costs between and within the different types of funds and this data cannot be wholly relied upon.

Our experience

From our experience we understand the needs of the superannuation industry and the benefits that benchmarked data would contribute toward increasing the operational efficiency of the entire system.

Superannuation

In an environment of increasingly expanding customer/ member value propositions the industry needs to re-align itself to the most important value driver to enhance retirement outcomes; maximising net return. Inculcating cost discipline and realising operational efficiency opportunities arguably form the most controllable and significant levers to maximise this.

Superannuation funds will be seeking to define their preferred customer/ member value propositions. Some will opt for value propositions that entail and justify comparatively higher operating costs (e.g. targeting and achieving investment returns considerably above CPI, delivering a superior experience by making interaction simpler or more tailored to the customer or member). Others will opt for a 'utility positioning', delivering undifferentiated customer / member service, but able to contain cost as a result of their standardised approach.

It is encouraging that funds can conceptualise and adopt radically different value propositions and, in consequence, employers and the fund beneficiary are likely to be faced with real alternatives rather than a plethora of almost identical propositions.

Nevertheless it seems unlikely that there will be a value proposition 'arms race' with funds trying to outdo one another to deliver more value more cost effectively. Meanwhile, cost efficiency will only result if management inclined in this direction have the information necessary to commute their aspiration into an operational reality.

Benchmarking

Third Horizon has an enviable track record in delivering actionable benchmark information to management. We recently, for example, conducted a whole of industry benchmarking study on behalf of the Australian Water industry representative body (WSAA) and its members. On the basis of our widespread and long-lived experience we've identified the following pre-requisites for benchmarking which encourages cost discipline:

- > **Buy in** - to achieve the best outcomes a study would need the support of a sufficiently large group of superannuation funds.
- > **Confidentiality** - a clearly established understanding of what is to be shared between the peer group and in what format coupled with an assurance that detailed individual results will only be disclosed to the participating entity.
- > **Exhaustive** - looks at 100% of the controllable opex base and captures and highlights erroneous categorisation of costs.

- > **Comparable** - only comparable costs are included in each benchmark category and only comparable peers (in terms of scope of operations, fund management style (active / passive), administration model etc.) are compared for each cost area.
- > **Confidence** - in the methodology/ approach (e.g. cost category normalisation criteria) and that the team compiling the benchmark data understand the sector (e.g. key cost drivers) such that executive teams across the sector can achieve buy-in from their teams and drive lasting change.

A suggested approach: whole of industry cost benchmarking

Method

- > We would propose to consider costs under three broad categories:
 1. Investment;
 2. Operational; and
 3. Administration
- > Each of these three categories would be split and benchmarked separately to allow for meaningful comparison between peers with different involvement across the value chain.
- > Multiple relevant normalisers would be collected and used to compare relative efficiency of spend.
- > *Please refer to our proposed allocation framework included in the appendix.*

Expected benefits

There are significant benefits to be expected from such an approach. Most pertinently:

- > Management will have the information necessary to realise their aspiration to instil cost discipline;
- > They will have access to previously unavailable cost benchmark data, specific to each relevant peer group; and
- > They will have the ability to leverage insights to identify and implement performance improvement or transformation programs which deliver sustainable cost reduction and increased competitiveness.

Of significance is that a greater cost focus from superannuation funds is likely to lead *ceteris paribus* to downward pressure on fees charged to customers/ members and as a result an improvement in retirement outcomes. Increasing the transparency and heightening expectations on costs would incentivise action within the industry to bring about the realisation of these desirable outcomes.

APPENDIX – Proposed Cost Allocation Framework

Investment Costs	Asset Management											Transaction Costs						Insurance					
	Fund Management					Reporting			Trustee Fees			Brokerage Fees			Contributions			Outgoing Payments			Insurance Related Costs		
	Domestic/international holdings	Performance Fees/Other Fees	Passive/Active Management	Custody fees	Asset class fees	Government/Regulatory	Fund performance	Member	Governance/legal	Marketing & Comms.	Audit/advisory	Buying/selling titles	Exchange fees	Currency conversions	Superstream	Employer Payment Processing	Additional contributions	Retirement benefits	Drawdown payments	Transfers	Premiums	Claims	Hedging gains/losses
Operational Costs	Employee					Infrastructure						Business Change		Other									
	Internal			Third-party contractors		IT			Buildings & Other			Internal change programs		"Other"									
	Normal wages	Pension contributions	Directors fees & expenses	Wages	Pension contribution	Legacy system maintenance	New technology spend	Digital	Rent	Running costs	Other overheads	One-off costs	Ongoing/recurring costs	Consultancy	Regulatory changes	Audit							
Administration Costs	Member Administration					Fund Administration					Customer Experience				Other Admin Expenses								
	Active/Retired Members					Reporting					Contact Centres		Digital Experience		"Other"								
	Contributions Summary	Yearly statements	Calls to action	Account management	Contact centres/other member services	Duplicate accounts	Consolidation	Member reporting	Data management	Regulatory reporting	Employer contribution reports	Payroll activities	Goodwill/complaint claims	Staff costs	Marketing & comms.	Digital member requests	Other	Regulatory changes	Consultancy	Audit			

THIRD HORIZON-

SYDNEY

Level 40, Grosvenor Place

225 George Street

Sydney NSW 2000

t +61 2 9333 6000

MELBOURNE

Level 34,

120 Collins Street

Melbourne VIC 3000

t +61 3 9094 2800

CANBERRA

Level 9,

60 Marcus Clarke Street

GPO Box 793 Canberra ACT 2601

t +61 2 6223 1500