MySuper consultation working group

Issues paper on Fees and costs

April 2011

PROPOSED REFORMS

As part of its Stronger Super package of reforms, the Government announced that it will determine the types of fees charged to members of MySuper products. There will be no entry fees and limits on exit and switching fees.

The fees that are currently charged to members can be divided into three categories.

First, there are account fees that all members must pay. Currently, these often include administration fees (either a fixed fee paid weekly or monthly or as a percentage of assets), investment fees (percentage of assets), and where applicable performance fees may be paid by the member. Although, in many cases, where performance fees are paid by the trustee it will form part of the normal investment fee. MySuper products will be permitted to charge members these fees.

Performance fees will only be permitted to be paid by the trustee of a MySuper product to an investment manager when the payment complies with parameters to be determined by the Government.

Second, there are certain fees that relate to costs incurred by the trustee as a result of an individual member's choice. It is appropriate for the member to be individually charged to recover these costs, rather than the costs being borne by the membership as a whole. However, these fees should only exist where member actions result in substantive and verifiable costs for the fund that can be demonstrably linked to the member's choice.

MySuper will be able to charge exit fees and switching fees on a cost recovery basis. This will prevent these fees from distorting competition between MySuper products. Switching fees will not be able to be paid to the trustee in their personal capacity or to any other party.

There are a range of other fees that fall into this category such as withdrawal fees, buy and sell spreads, contribution splitting fees, family law fees etc. However, these fees may not be able to be demonstrably linked to a member's choice, and allowing these fees to be charged to members may erode the comparability objective of the MySuper product. Therefore, it may be more appropriate for these costs to be recovered as part of the fees that all members must pay.

Third, fees for financial advice are currently charged in various forms. For example, entry fees (or contribution fees) that are usually used to remunerate financial advisers will not be permitted. An issues paper on financial advice discussed the deduction of individual member accounts for personal or general advice consistent with the Future of Financial Advice reforms. However, intra-fund advice will be able to be bundled as part of fees that all members must pay.

Finally, a fair and reasonable allocation of costs between MySuper and other products will allow funds to have common services across all members such as administration, but ensure that there is no cross-subsidisation of fees between MySuper and choice members.

Objectives

The purpose of these reforms is to have fees charged to MySuper members that are representative of the costs associated with their account and facilitate easier comparisons of MySuper products by limiting the types of fees that members are paying. The greater number of fees that can be charged on various transactions or bases, the more difficult it becomes for members to understand the fees paid and make comparisons.

The purpose of performance fee parameters will be to ensure that the payment of these fees by the trustee is in the members' best interests by reflecting genuine outperformance achieved by the investment manager.

Issues

Issue 1 – Exit and switching fees

The Government will determine the types of fees that can be charged on MySuper products, including limits on exit and switching fees (recommendations 1.7(e), (f), and (k)). Exit fees and switching fees will be permitted to be charged on a cost-recovery basis.

There are existing definitions for these fees in the *Corporations Regulations 2001*. However, these definitions may not be directly applicable to MySuper products because it has a single investment strategy, although members will be able to switch to a choice product in the same fund.

An exit fee should only be payable when the member terminates their account, and leaves the fund entirely. In other words, it should not be payable when the member moves to a choice product within the fund. Currently, exit fees recover the administrative and transactional costs of the member leaving the fund. These costs will have to be determined by the trustee in setting an appropriate exit fee for the MySuper product.

A switching fee should only be payable when a member changes their investment option for part or all of their balance. Switching fees cover the administrative and transactional costs of transferring a member from one investment option to another investment option within the same fund. By definition, a member in a MySuper product will only be charged a switching fee when switching some or all of their balance to a choice product of the same fund. They will not be able to be paid to the trustee in their personal capacity or to any other party, and consequently must be paid into the fund. This will remove an incentive for trustees to advise members to switch investment options.

Currently, some funds may only charge switching fees after a certain number of switches. This may not constitute cost-recovery, as those making free switches are subsidised either by the whole membership or by members making several switches.

Question 1.1 What costs should be able to be recovered through an exit fee?

Question 1.2 What costs should be able to be recovered through a switching fee? Are there any consequences with requiring switching fees to be paid into the fund and not to the trustee?

Question 1.3 Should switching fees be payable from the first switch or should free switches be allowed?

Question 1.4 Are there any other types of transactional fees that should be permitted to be charged to MySuper members? If so, should they also be on a cost-recovery basis?

Issue 2 – Investment fees

The costs of investment can be passed onto members through a combination of ongoing percentage based investment fees, a range of transactional fees or netting off fees prior to reporting investment returns.

Transactional fees pass on costs incurred by the fund in managing assets, for example brokerage or stamp duty. One type of transaction fee is a buy or sell spread paid by members when increasing or decreasing units in the fund or their account balance.

However, it is difficult to directly attribute transactional costs to the choices of any individual member. All member assets are pooled and the member holds a notional share of all assets, not a separately identifiable set of assets. For example, members leaving the fund may have these requests met with the contributions recently received by the fund. Therefore, there may be no change to the overall invested pool of assets, and incoming cash flow is used to meet outflows.

Costs incurred in buying and selling assets will also occur if the trustee alters the asset allocation of the fund, or when changes in asset valuations mean that assets have to be sold or purchased in order to maintain the fund's asset allocation.

There would not appear to be a demonstrable link between transactional fees and the actions of any particular member, which would mean that it would not satisfy the principle for a separate fee in a MySuper product. Rather, these costs are incurred in the ordinary course of managing investments so could be recovered as part of the ongoing investment or administration fee charged to all members.

It is also an existing practice for some funds and investment fund managers to deduct costs from investment returns, rather than being paid a fee. This results in a lower return than that received on the underlying investments being credited to member accounts or the unit price. Passing investment costs to members by deducting them from investment returns is not transparent and could impede comparisons of MySuper products.

Question 2.1 Should buy and sell spreads or any other transaction fee be permitted in the MySuper product? And if so, why?

Question 2.2 Are there any problems with requiring all investment costs to be passed onto members in the form of an explicit fee?

Issue 3 – Performance-based fees

The Government will determine parameters under which trustees can pay performance fees to fund managers in respect of the investments of the MySuper product (recommendations 1.7(h), 3.2 and 3.3). Currently, performance-based fees are used by trustees as an incentive for outperformance against a given benchmark by investment managers. It is argued that this aligns the interests of members and the trustee with the interests of the investment manager.

However, the Super System Review identified a range of concerns with the current structure of performance fees that mean they may not always be in the member's best interests. One example is inappropriate hurdle rates that result in payment of performance fees for average performance.

The parameters under which performance fees can be paid could comprise a set of high-level principles to minimise the possibility that a fee is paid for market volatility and not for genuine outperformance as a result of manager skill.

This approach would specify principles that the contractual arrangements between trustees and investment managers must include, such as:

- a reduced base fee that reflects the potential gains the investment manager receives from performance fees taking into account any fee cap;
- measurement of performance on an after-tax and after-costs basis;
- an appropriate benchmark and hurdle for the asset class reflecting the risks of the actual investments;
- an appropriate testing period; and
- provisions for the adjustment of the performance fee to recoup any prior or subsequent underperformance, including using provisions such as high water marks, clawbacks, vesting arrangements and rolling testing periods.

In contrast, a more prescriptive approach would provide trustees with certainty on those performance fees that comply with the standard. For example, this approach could require the testing period for the performance fee to be two years or more.

Question 3.1 Should a principles-based or prescriptive approach be used in setting a performance fee standard? What principles or criteria would ensure that performance fees are only paid for genuine outperformance?

Question 3.2 Should the standard only apply in respect of the investments of the MySuper product or the entire fund?

Issue 4 – Fair and reasonable allocation of costs

Trustees will be required to make a fair and reasonable allocation of costs between MySuper and other products (recommendation 1.7 (d)). This aims to have MySuper products charge fees that represent the costs attributable to the MySuper product, not the costs of the fund as a whole (if it offers choice products).

For example, a fund that offers intra-fund advice may allocate those costs based on the estimated use by members in the MySuper product versus the choice products. If the intra-fund advice facility is accessed 90 per cent of the time by choice product members and 10 per cent by MySuper members, then only 10 per cent of the costs should be attributed to the MySuper product.

However, other costs may only be able to be allocated between members in the MySuper product and choice products using a simpler approach, such as the number of members or size of assets in each product. For example, call centre costs, member communication such as websites, and marketing costs.

A fair and reasonable allocation of costs will ensure that members of the MySuper product do not pay for services they do not use, and do not subsidise services provided to members of choice products.

Question 4.1 Should there be a standard methodology for making a fair and reasonable allocation of costs between MySuper and choice products?

Issue 5 – Fees in choice products

Trustees of choice products will not be able to charge entry fees and limits would apply to exit and switching fees (response to recommendation 1.20). It is proposed that choice products would not be restrained in any other type of fee that can be charged to members.

If a fund did charge either exit or switching fees the same requirements that apply to MySuper products would apply to choice products. Namely, that they are charged on a cost-recovery basis and switching fees could not be paid to the trustee in their personal capacity. A different treatment of these fees would create regulatory imbalances that may create opportunities for arbitrage.

Question 5.1 What are the advantages and disadvantages of limiting exit and switching fees to a cost-recovery basis in choice products?

Question 5.2 Are there any other fees that should be restricted for choice products?