Keywords: superannuation, outsourcing, related-party service providers.

AUSTRALIAN SUPERANNUATION OUTSOURCING

This paper describes the outsourcing landscape of the Australian superannuation sector, and provides context for further examination of the outsourcing-related challenges that it faces. Our findings indicate that outsourcing is widespread within the sector, and a substantial number of outsourcing arrangements are with related parties. Not-for-profit funds are generally more likely to outsource than their retail counterparts, and when retail funds outsource, they are more likely to use affiliated service providers.[1]

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Superannuation is big business in Australia — some 1.23 trillion dollars' worth. However, the day-to-day administration of the business has grown beyond the collective capacity of the fund trustees charged with protecting the interests of members. As a result, superannuation trustees are heavily dependent on outsourcing arrangements, many of which involve related-party service providers.

Industry dynamics

While private pension plans have a century-long history in Australia, the magnitude of the superannuation industry today is the direct result of the 1992 passage of the Superannuation Guarantee. The Superannuation Guarantee gave birth to a comprehensive system of private retirement accounts, funded by compulsory wage- or salary-based contributions, tax-deductible to the employer and held in tax-effective superannuation funds. Critically, the Superannuation Guarantee gives employees the right both to choose the fund which receives the contributions, and to transfer amounts in their individual accounts from one fund to another. The Superannuation Guarantee raised the stakes — massively increasing the amount of money flowing into the superannuation system — while the *Superannuation Industry (Superannuation) Act 1993 (SIS Act)* transformed the competitive landscape.

Historically, there have been four distinct types of APRA-regulated superannuation funds. 'Public-sector' funds were originally established to provide pension benefits to certain groups of state and federal government employees. 'Corporate' funds developed to service the employees of a single company, and 'industry' funds cater to unionised workers in a single industry. Membership in these three types of funds (collectively, the 'not-for-profit' sector) was both closed and mutually exclusive, thus the funds properly did not consider themselves to be competitors. 'Retail' funds first came into being to cater to employers not large enough to justify their own dedicated funds, and to individuals not eligible for not-for-profit funds, such as professionals and other self-employed individuals. Retail funds also offered a home to lump sums rolling out of not-for-profit funds.

The SIS Act allowed public-sector, corporate, and industry funds to become 'public-offer' funds (SIS Act s.18). Not only would these funds continue to provide superannuation to their established constituencies, but they could also offer membership to the general public, in direct competition with retail funds and with each other.

Based on the most recent APRA statistical release (APRA 2010), retail funds accounted for 27.6 per cent of all superannuation assets. Industry funds accounted for 18.4 per cent;

public-sector funds, 14.3 per cent; and corporate funds, 4.6 per cent, making a total for the not-for-profit sector of 37.2 per cent. Most of the balance, 31.8 per cent of assets, was held in self-managed superannuation funds (which are not regulated by APRA). The assets accumulated in superannuation schemes constitute the highest *per capita* investment of this type in the world (Australian Finance Group 2009).

In most cases, an Australian superannuation fund is constituted in the form of a trust, where the trustee is a special-purpose corporation. Typically, the board of the corporate trustee of a corporate or industry fund is composed of a predetermined number of employer-, union-, or member-affiliated representatives, and the company is run on a not-for-profit basis. On the other hand, the trustee of a retail fund is usually a corporate member of a financial-services group such as a bank or insurance holding company.

The trust structure makes outsourcing natural. Not only do trustees contract out professional services, but often they also use third-party service providers to run day-to-day operations. In this regard, though, not-for-profit and retail funds take very different approaches. For not-for-profit funds, outsourcing is a function of minimising member expense. In some cases, third parties can provide services at a cost less than if the trustees were to perform the function themselves. In other cases, several not-for-profit funds join in collaborative ventures, thereby attaining economies of scale without paying third-party profits. A third category of outsourcing in the not-for-profit space relates to corporate funds established by financial services firms for their own employees. These funds often use the services of the employer, but the outsourcing arrangement is not intended to benefit the service provider at the expense of the members.

This is patently not the case when the trustees of retail funds contract services to affiliates. As Liu and Arnold (2010) have been able to establish, retail-fund outsourcing to affiliated service providers, particularly in respect of administrative services, can result in significantly higher costs for members. This supports the hypothesis that outsourcing by not-for-profit funds is driven by functionality and/or cost-efficiency, while outsourcing by retail funds is integral to the revenue model.

The data

In late 2006, APRA collected data from the trustees of all superannuation funds with assets in excess of $200 million, relating to, *inter alia*, outsourcing arrangements across eight key functions: actuarial services; administration; asset allocation; auditing; custody; investment management; legal services; and sales and marketing. Trustees were asked to identify all service providers to which 5 per cent or more of the functions were outsourced, and to disclose the level of compensation paid to the service provider. We augmented the survey data with information from both an APRA-maintained directory of service providers and quarterly information returns lodged with APRA. While 187 superannuation funds responded, other APRA studies have been limited to the 115 funds able to provide five-year fund-level investment performance data. Those same 115 funds are examined here.

We undertook to examine the relationship between the service provider and the superannuation trustee. This required us to classify each service provider as an independent party or related to the trustee. Service providers were deemed 'related' if they were owned by the trustee company, if the service provider and trustee company were members of the same consolidated group or, in the case of not-for-profit funds, if the service provider was a collaborative venture. We use the term 'nominal' to refer to any formal outsourcing arrangement, whether the service provider is related or independent; 'effective' refers only to arrangements with independent service providers.

For each fund and for each function of interest, we consolidated individual outsourcing arrangements to determine an aggregate level of outsourcing. We chose to ignore outsourcing arrangements where the respondent noted that less than 10 per cent of a function had been outsourced, which suggests that the trustee had retained almost complete control of the function, but perhaps used a service provider for one or more small tasks.

The trust structure makes outsourcing natural. Not only do trustees contract out professional services, but often they also use third-party service providers to run day-to-day operations. In this regard, though, not-for-profit and retail funds take very different approaches.

TABLE 1: Number of functions outsourced

Nominal (Effective)	1	2	3	4	5	6	7	8	Total
Not-for-Profit			(3)	5 (8)	11 (24)	31 (29)	30 (18)	6 (1)	83
Retail	(5)	(6)	15 (11)	6 (7)	5 (1)	2 (2)	3	1	32
Total	(5)	(6)	15 (14)	11 (15)	16 (25)	33 (31)	33 (18)	7 (1)	115

Note: 'Nominal' refers to any formal outsourcing arrangement, whether the service provider is related or independent; 'effective' refers only to arrangements with independent service providers.

TABLE 2: Outsourcing — all functions, all funds

	Not-for-Profit				
Nominal (Effective)	**No PO**	**Public Offer**	**All NFP**	**Retail**	**All**
Number of funds	55	28	83	32	**115**
Actuarial Services	42 (42)	9 (8)	51 (50)	6 (3)	**57 (53)**
Administrative Services	46 (33)	25 (15)	71 (48)	21 (6)	**92 (54)**
Asset Allocation	52 (44)	27 (22)	79 (66)	12 (5)	**91 (71)**
Auditing	55 (55)	28 (28)	83 (83)	32 (32)	**115 (115)**
Custody	36 (32)	26 (26)	62 (58)	19 (17)	**81 (75)**
Investment Management	46 (46)	27 (27)	73 (73)	32 (26)	**115 (109)**
Legal Services	49 (49)	25 (21)	74 (70)	9 (6)	**83 (76)**
Sales and Marketing	5 (2)	9 (7)	14 (9)	4 (0)	**18 (9)**

Note: 'Nominal' refers to any formal outsourcing arrangement, whether the service provider is related or independent; 'effective' refers only to arrangements with independent service providers.

The extent of outsourcing

Every single respondent outsourced at least one function, and nearly two-thirds of the funds outsourced six or more. Table 1 sets out the frequency of outsourcing by superannuation fund sector.

While not-for-profit and retail funds both outsource, the tendency to outsource most or all of the functions is greater for not-for-profit funds. Of 83 not-for-profit funds, 67 outsourced six or more functions, while 29 of 32 retail funds outsourced four or fewer to independent service providers.

Table 2 shows the extent, by function, to which superannuation funds choose to outsource, further distinguishing within the not-for-profit sector by whether the fund features a public offer. Note that outsourcing is mandatory in the case of auditing, as APRA requires the appointment of an independent auditor. At the same time, every fund entered into formal outsourcing arrangements for investment management; except for six retail funds, at least one investment manager was independent of the trustee.

Figure 1 illustrates the pattern of outsourcing by fund sector. Note that the following data relate to the aggregate level of outsourcing, rather than whether a given fund has chosen to outsource some or all of the function. Thus, for example, while every superannuation fund outsources investment management, not every fund outsources all of its investment management.

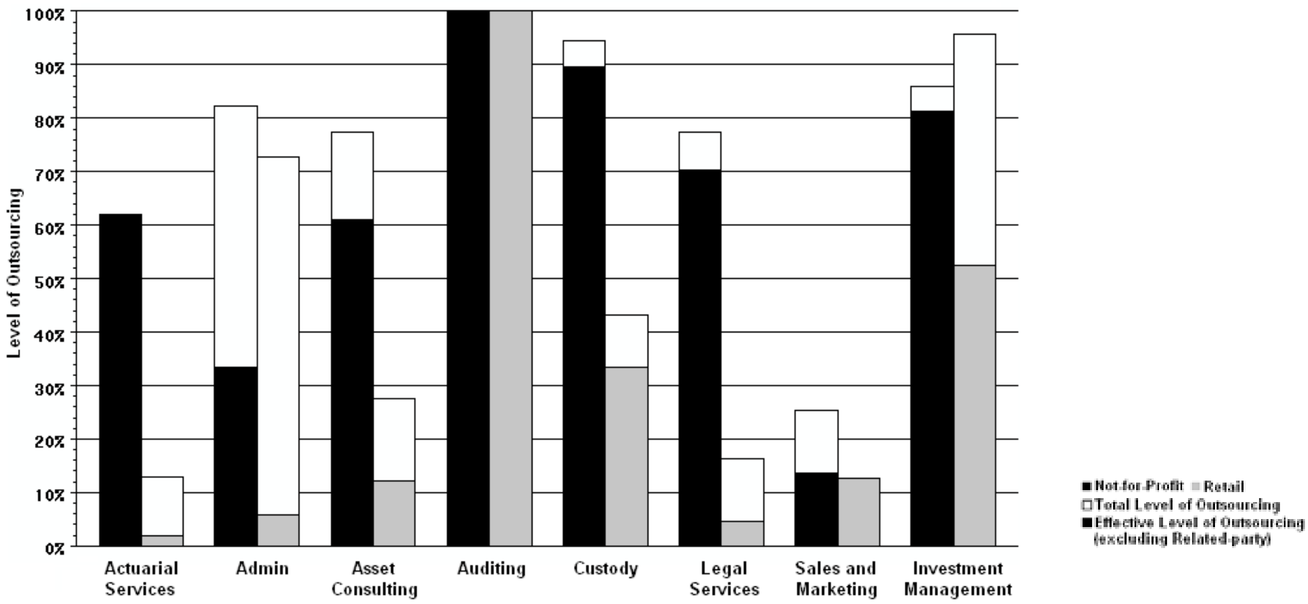
While not-for-profit and retail funds both outsource, the tendency to outsource most or all of the functions is greater for not-for-profit funds.

In the two key areas of administration and investment management, while retail funds are as likely to outsource as not-for-profit funds, a substantially greater portion of the arrangements are with related parties, as shown by the larger white segment of the respective bars.

The decision to outsource

We tested the tendency to outsource first by sector. Within the not-for-profit sector, we also tested by whether the fund featured a public offer ('PO NFP' vs 'NoPO NFP'), querying whether the addition of a public-offer feature would have caused a not-for-profit fund to act more like a retail fund. Our principal test of significance was Fisher's exact test (Fisher 1922), which tests the null hypothesis that the probability of a trustee's electing to outsource is

FIGURE 1: Nominal and effective outsourcing by fund sector — all functions



not conditional on the group to which the trustee belongs. Fisher's exact test returns a *'p-value'*, which indicates the probability that any pattern in the data could have been produced by random variation, rather than a statistical difference in the comparison groups.

Selected comparison-testing results are set out in Table 3. In respect of four functions — actuarial services, administration, asset allocation, and legal services — not-for-profit funds show a significantly higher tendency to outsource when compared to retail funds, particularly when one looks through nominal outsourcing arrangements with affiliated service providers. There was no evidence that the public-offer feature affected the decision to outsource.

In respect of sales and marketing, only two non-public offer funds used independent sales and marketing service providers, which is only natural as they would have had little need to market their services to their (closed) membership. The relevant comparison, then, is between retail funds and public-offer not-for-profit funds, as reported in Table 3. While there was relatively little outsourcing of sales and marketing by either type of fund, it is noteworthy that every single formal outsourcing arrangement by a retail fund was with a related party. Thus the marginally significant difference in nominal outsourcing between the two groups became an overwhelmingly significant difference in effective outsourcing.

TABLE 3: Fisher's exact test probabilities — nominal (effective)

Comparison Group	Not-for-Profit vs Retail	PO NFP vs NoPO NFP	PO NFP vs Retail	NoPO NFP vs Retail
Actuarial (funds with defined-benefit component only)	0.031*** (0.001***)			
Administrative Services	0.035** (<0.001***)	0.743 (0.642)		
Asset Allocation	<0.001*** (<0.001***)	1.000 (1.000)		
Legal Services	<0.001*** (<0.001***)	1.000 (0.116)		
Sales and Marketing (public-offer funds only)			0.115 (0.003***)	
Custody	0.117 (0.126)	0.007*** (0.001***)	0.003*** (0.001***)	0.647 (0.661)

TABLE 4: *Number of service providers — all functions, all funds*

Nominal (Effective)		**0**	**1**	**2**	**3 or more**
Actuarial Services	**NoPO NFP**	13 (13)	42 (42)		
	PO NFP	19 (20)	9 (8)		
	Retail	26 (29)	6 (3)		
Administrative Services	**NoPO NFP**	9 (22)	41 (30)	3 (1)	2 (2)
	PO NFP	3 (12)	21 (16)	2 (0)	2 (0)
	Retail	11 (26)	19 (6)	2 (0)	0 (0)
Asset Allocation	**NoPO NFP**	7 (15)	44 (36)	4 (4)	
	PO NFP	4 (9)	21 (17)	1 (0)	2 (2)
	Retail	22 (28)	9 (4)	1 (0)	
Auditing	**NoPO NFP**		40 (40)	15 (15)	
	PO NFP		20 (20)	6 (6)	2 (2)
	Retail		31 (31)	1 (1)	
Custody	**NoPO NFP**	19 (23)	35 (32)	1 (0)	
	PO NFP	2 (2)	24 (24)	2 (2)	
	Retail	13 (15)	19 (17)		
Legal Services	**NoPO NFP**	6 (6)	39 (40)	9 (8)	1 (1)
	PO NFP	3 (7)	13 (11)	6 (7)	6 (3)
	Retail	23 (26)	6 (3)	1 (3)	2 (0)
Sales and Marketing	**NoPO NFP**	49 (52)	5 (2)		1 (1)
	PO NFP	19 (21)	7 (5)	1 (1)	1 (1)
	Retail	28 (32)	4 (0)		
All Functions (except Investment Management)	**NoPO NFP**	**26.8% (34.0%)**	**63.9% (57.7%)**	**8.3% (7.3%)**	**1.0% (1.0%)**
	PO NFP	**25.5% (36.2%)**	**58.7% (51.5%)**	**8.7% (7.7%)**	**7.1% (4.6%)**
	Retail	**54.9% (69.6%)**	**42.0% (28.6%)**	**2.2% (1.8%)**	**0.9% (0.0%)**
Nominal (Effective)		***1***	***2-4***	***5-10***	***11-37***
Investment Management	**NoPO NFP**	3 (3)	8 (9)	14 (13)	12 (21)
	PO NFP	3 (4)	4 (3)	9 (9)	11 (11)
	Retail	9 (3)	2 (1)	5 (5)	1 (1)

Note: 'Nominal' refers to any formal outsourcing arrangement, whether the service provider is related or independent; 'effective' refers only to arrangements with independent service providers.

The only clear break in this pattern was in respect of custodial services. At first glance, there would appear to be the same difference between not-for-profit and retail funds. However, a closer analysis shows that the difference is driven almost completely by the public-offer funds. These funds show a significantly higher propensity to outsource than their non-public offer counterparts, while non-public offer NFP funds are very similar to retail funds in their decision to outsource custody.

In general, the decision to outsource is not dependent on either the number of members in a fund or fund assets, with a few exceptions: smaller not-for-profit funds are more likely to outsource asset allocation, while larger NoPO NFP funds are more likely to outsource custody. (Regression results are not reported.)

Number of service providers

For all key functions other than investment management, when the trustees of superannuation funds chose to outsource, most often they selected a single service provider. Not-for-profit funds, which tended to outsource more, also tended to use two or more service providers more frequently than their retail counterparts. The data are set out in Table 4.

Future directions

The prevalence of outsourcing in the superannuation industry raises a number of issues relating to fund governance. While there are obvious benefits to outsourcing (for example, benefits of scale, improved delivery, and access to external expertise; see Harland et al. 2005), there are also several layers of risk which outsourcing imposes, especially operational and compliance risk in respect of the service provider. Furthermore, these risks impose additional duties on superannuation trustees, in that they must develop the capacity to select, contract with, and monitor service providers (see, for example, Federal Reserve Bank of New York 1999). Finally, the substantial number of related-party arrangements raises a crucial governance issue. Superannuation trustees have a legal duty to act in the best interest of fund members when they award, negotiate, and monitor outsourcing contracts (see, for example, Freeman and Brown 2008). How well trustees discharge this duty when the party across the bargaining table is related is critical to the faith members place in the superannuation system. ■

Note

1. This is an abridged and modified version of an APRA working paper, 'Australian superannuation — the outsourcing landscape', 12 July 2010, and available at www.apra.gov.au/ Research/ upload/ SA_WP_ASOL_072010_overview-3.pdf

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