



# Market Discipline in Superannuation

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Outline 

- 1. Market discipline in banking**
  - What is market discipline?
  - What are the mechanisms and pre-conditions for effective discipline?
- 2. The superannuation industry - some background**
  - An outline of the industry and basic statistics
  - An outline of a super fund
  - Public and private information
- 3. Can market discipline be applied to superannuation?**
  - What risks may be mitigated by market discipline?
  - What are the mechanisms and pre-conditions for effective discipline?
- 4. Summary and Conclusions**

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1. Market discipline in banking 

**What is market discipline?**

The ability of third-party claimants (eg debt holders and equity holders) to identify risk in financial institutions, and to act in a way that signals those risks (to regulators), or changes the behaviour of the financial institution.

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## 1. Market discipline in banking (cont.)



## Two components of market discipline

*Market monitoring*: risks are promptly impounded into a firm's stock and bond prices (hence information is created that supervisors and others can use).

*Market influence*: the ability of market participants to change a firm's financial decisions. For example, funds are withdrawn from a bank, which affects the funding strategy of the bank, or forces it to reduce its size or risk.

(see Bliss and Flannery (2001))

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## 1. Market discipline in Banking (cont.)



## What are the benefits of market discipline?

- Private investors, who are risking their own capital, have a strong *incentive* to correctly predict that a financial institution will get into trouble.
- Market discipline is suited to analysing *complex* institutions, and is likely to respond more quickly than regulations to *innovations* that change the risk profile of financial institutions.
- Empirical evidence generally supports the hypothesis that information impounded in market prices can help *forecast* financial failure.

(see Flannery and Nikolova (2003))

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1. Market discipline in Banking (cont.)

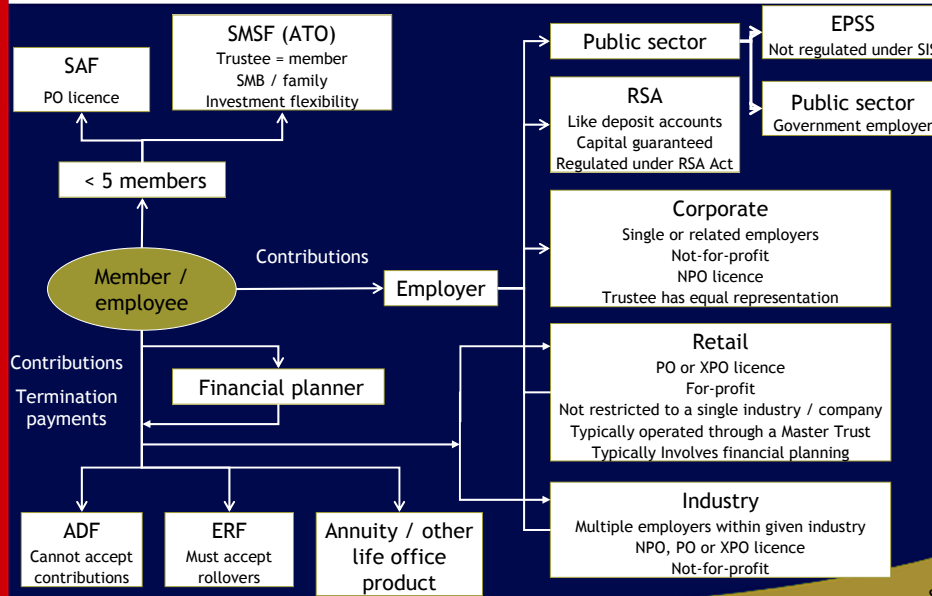


Mechanisms and pre-conditions

Market Discipline	Mechanism	Pre-conditions
Large Depositors	Withdrawal of funds	<ul style="list-style-type: none"> <li>No implicit or explicit safety-net</li> <li>Adequate and timely disclosure</li> </ul>
Subordinated Debt	Pricing / cease funding	<ul style="list-style-type: none"> <li>No implicit or explicit safety-net</li> <li>Held by independent institutional investors</li> <li>Active trading or short maturity</li> </ul>
Equity Markets	Pricing / Access to additional capital	<ul style="list-style-type: none"> <li>Market listing</li> <li>Liquidity</li> </ul>
Specialised Information Firms	Ratings affect pricing and funding	<ul style="list-style-type: none"> <li>Market demand for ratings</li> <li>Profit tied to reputation</li> </ul>

(see Caprio and Honohan (2003))

2.1 An outline of the superannuation industry



2.1 Some Super Industry Statistics



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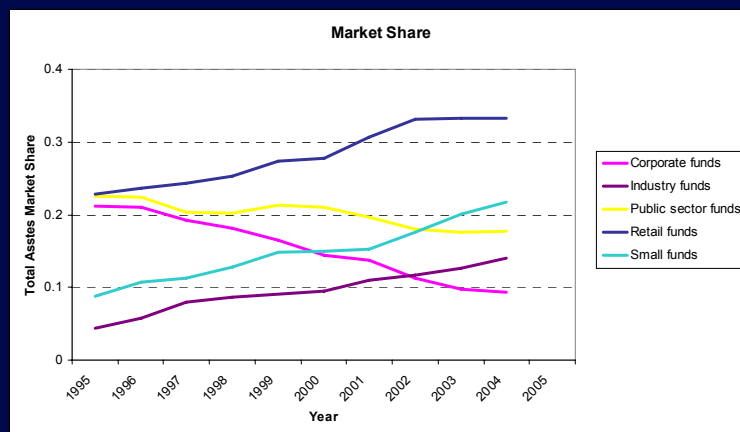
	Assets (\$ billion)		Number of entities	
	Mar 05	Mar 04	Mar 05	Mar 04
<i>By fund type (\$b)</i>				
Corporate	65.0	55.7	1,060	1,552
Industry	104.3	81.0	87	104
Public sector	122.7	105.5	39	39
Retail	235.0	201.3	226	252
<b>Sub total</b>	<b>527.0</b>	<b>443.5</b>	<b>1,412</b>	<b>1,947</b>
Small APRA funds	3.3	2.9	7,376	7,816
Single-member ADFs	0.1	0.1	203	228
Self-managed super funds	159.5	126.0	295,287	274,441
Balance of life office statutory funds	20.0	28.5		
<b>Total</b>	<b>710.0</b>	<b>601.0</b>	<b>304,278</b>	<b>284,432</b>

Source: Quarterly Superannuation Performance, March 2005.

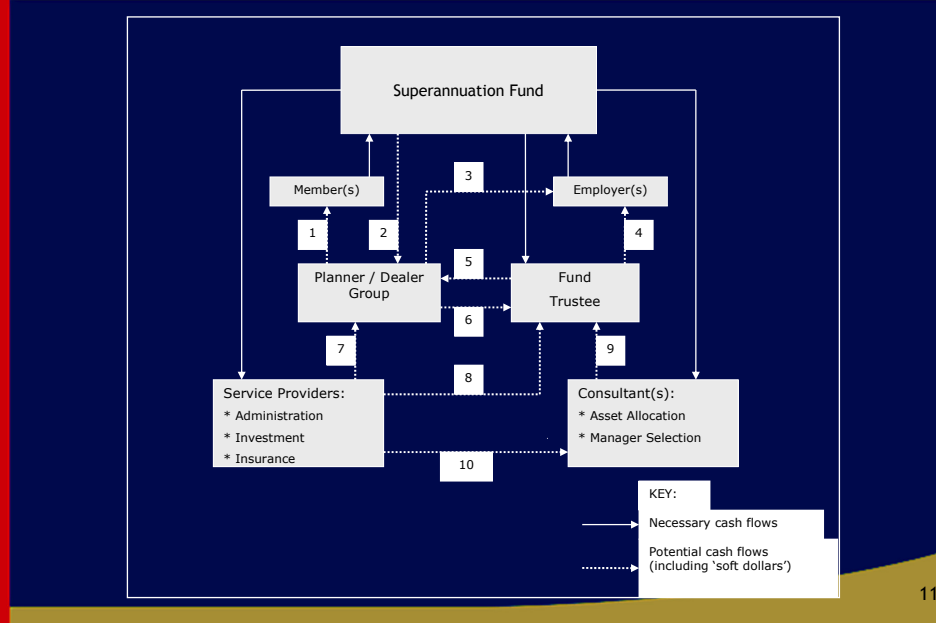
2.1 Some Super Industry Statistics (cont.)



APRA




2.2 An outline of a superannuation fund



2.3 Publicly Available Information on Super Funds



Data Source	Coverage	Performance Data	Fee Data
AFR (Morningstar-based)	Over 900 managed funds	6 month 1,2,3,4,5,6,7 year plus volatility measure Asset allocation	Entry, exit, MER
InvestorWeb (Morningstar-based)	2,541 super and rollover fund options 324 wholesale PST options	6 month 1,2,3,5, year Relative to 'sector' Quarterly asset allocation for past year	Entry, exit, MER, Switching
Morningstar	2,930 super fund options	3 month (top 10 retail funds only) 6 month 1,3,5,7 year	Entry, exit, MER
Selecting Super	Top 50 super rated funds by investment option (performance) Top 10 rated super funds by fund type (fees)	Performance measured by crediting rate	Fees measured by total expense ratio (TER)
SuperRatings	Top 5 rated super funds by investment option	Fiscal year to date 1,3,5 year	n/a

2.4 Privately Available Information on Super Funds 

Data Source	Coverage	Description of Data
Assirt	Managed funds (incl. super funds & PSTs) (>1,000 Assirt-rated managed funds, 35 Assirt-rated fund managers)	Assirt database containing asset allocation, performance (1,3,6 month 1,3,5,7 year, cumulative 5 year), fees and commissions and other information.
Bloomberg	Managed funds (incl. super funds & PSTs)	Daily unit price series by investment option.
InTech	Super funds (>180) and PSTs (> 60) Sector funds (>430)	Various surveys which include information on a range of risk-adjusted performance measures, fees, asset allocation, risk and market indices.
Morningstar	Managed funds (incl. super funds) (> 6,000)	Morningstar database containing information on returns, asset allocation, performance statistics (6 month, 1,3,5,7 year), fees and other information.
Selecting Super	Super funds rated by Selecting Super (> 160 funds)	Comparison of investment performance (1,3,5 year), investment choices, fees, insurance and other information of selected super funds.
SuperRatings	Super funds rated by SuperRatings (132 funds, almost \$300 billion in assets)	Key features, options, fees, insurance cover, performance relative to industry and other information

3. Market discipline in Superannuation 

**What are the potential benefits?**

- *Incentive and ability* to correctly predict whether a super fund or trustee will under-perform, and to identify and price conflicts of interest.
- Ability to analyse and compare **complex** products, and to focus on appropriate risk-adjusted measures of performance.
- Information signals may facilitate decision-making by regulators and super fund beneficiaries.

3. Market discipline in Super (cont.)



What are the risks that market discipline may mitigate?

- Agency risk  
Are the trustee’s duties and powers exercised in the best interests of the beneficiaries?
- Operational Risk  
Is the trustee efficiently and appropriately managing (or outsourcing) the operations of the fund (eg administration, custody of assets, insurance, investment managers, asset consultants etc).
- Investment Risk  
Is the investment strategy appropriately diversified, liquid, and matched to liabilities?

3.1 Market Discipline in super

Mechanisms and Preconditions



Market Discipline	Mechanism	Preconditions
Members	Withdrawal of funds	<ul style="list-style-type: none"> <li>• Choice of fund</li> <li>• Low switching costs</li> <li>• Adequate and timely disclosure (risk-adjusted performance measures)</li> <li>• Informed members with sufficiently large account balances</li> </ul>
Advisors and Information Specialists	Withdrawal of funds	<ul style="list-style-type: none"> <li>• Independent</li> <li>• Interests aligned with members</li> <li>• Profit model built on reputation</li> </ul>

3.1 Mechanisms and Preconditions (cont.)



Market Discipline	Mechanism	Pre-conditions
"Directors"	Incentive compatible arrangements	<ul style="list-style-type: none"> <li>• "Skin in the game" (<i>Cremers, Driesen, Maenhout, Weinbaum (2005)</i>)</li> <li>• Understanding that inadequate attention to conflicts of interest can impact on revenue, expenses, risk, and ultimately survival (Ingo Walter (2003)).</li> </ul>

4. Summary: Comparing Banking and Super



ISSUE	BANKING	SUPERANNUATION
Role of market discipline	<ul style="list-style-type: none"> <li>• Help predict failure and influence firm risk-taking behaviour.</li> </ul>	<ul style="list-style-type: none"> <li>• Help predict underperformance, influence operating behaviour, and mitigate agency risks.</li> </ul>
Complexity and opacity of asset portfolio	<ul style="list-style-type: none"> <li>• Largely non-traded assets.</li> <li>• Large private-information component.</li> <li>• Complex non-linear exposures</li> </ul>	<ul style="list-style-type: none"> <li>• Largely traded assets, mostly daily pricing.</li> <li>• Complexity of the product</li> </ul>
Market pricing and funding (third-party)	<ul style="list-style-type: none"> <li>• Active debt and equity markets</li> <li>• Short-term funding instruments and deposit withdrawal</li> </ul>	<ul style="list-style-type: none"> <li>• No forward looking market price.</li> <li>• Funding withdrawal (choice of fund)</li> </ul>
Specialist information providers	<ul style="list-style-type: none"> <li>• Reputable, extensive and independent</li> </ul>	<ul style="list-style-type: none"> <li>• Limited coverage</li> <li>• Largely non-independent</li> </ul>
Information disclosure	<ul style="list-style-type: none"> <li>• Extensive and expanding under Basel II</li> </ul>	<ul style="list-style-type: none"> <li>• Risk-adjusted performance measures difficult to gather</li> </ul>

## 4.1 Conclusions



- Although there are no (forward looking) market prices, there is still a role for market discipline in superannuation.
- Market discipline is suited to analysing and responding to exploitation of conflicts of interest, conflicts that are often extremely granular and sometimes involve conduct that is “inappropriate” or “unethical” rather than “illegal”.  
*(Ingo Walter 2003)*
- Policies that promote market discipline (timely, consistent and effective disclosure; investment choice; incentive compatible contracts; and forward looking market prices) should be encouraged.
- Market oversight of investment managers exists (backward and forward looking measures). Why not trustees?