Lifting the Bar:
Underperforming MySuper Products

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Executive summary

ASFA supports action to target underperformance in MySuper products and holding funds to account for underperformance, including enabling consumers to better compare MySuper products.

However, ASFA is concerned that the policy announced on Budget Night 2020 – *Holding funds to account for underperformance* (Holding Funds to Account) will have unintended consequences and undermine confidence in the system.

In this paper ASFA suggests that, rather using the 'Holding Funds to Account' mechanism proposed in the 2020 Budget, there should be a one-off 'Lifting the Bar' assessment applied to existing MySuper products and that the annual Member Outcomes Assessment should be utilised to determine whether a fund is considered to be underperforming on an ongoing basis.

This one-off assessment would achieve the same objective – to target high fees and costs and chronic underperformance. It would, however, avoid some of the unintended consequences of the Holding Funds to Account mechanism of driving fund investment decisions to track towards the APRA benchmark.

One-off 'Lifting the Bar' assessment

The assessment would comprise two stages:

Stage 1: the product's fees and costs (representative member basis) would be measured against a benchmark. If a product's fees and costs exceed the benchmark, the product would be assessed under Stage 2.

Stage 2: the product's net investment returns would be assessed and benchmarked.

Prima facie underperforming products would have an opportunity to state its case to APRA as to why its MySuper authorisation should be retained – if unsuccessful the MySuper authorisation would be revoked.

If the 'Holding Funds to Account' assessment is adopted on an ongoing basis, ASFA submits that it should be accompanied by the 'Case to Remain' mechanism proposed in section 5 of this paper.

1. Determining ‘underperformance’

ASFA suggests that a one-off ‘Lifting the Bar’ assessment would apply to all MySuper products.

This would be comprised of a two-stage assessment:

> **Stage 1:** the product’s fees and costs would be compared to a benchmark. If a product’s fees and costs exceed the benchmark the product would be assessed under Stage 2.
>
> **Stage 2:** the product’s net investment returns would be assessed and benchmarked.

If a MySuper product does not pass Stage 2 there would be an opportunity to state its case to APRA as to why it should retain its MySuper authorisation (‘Case to Remain’).

2. Stage 1: Fees and costs

ASFA suggests that a MySuper product's total fees and costs (on a representative member—$50k balance—basis) would be measured against a benchmark of **130 basis points** (which is one standard deviation away from the industry average for a representative member).

Total fees and costs would include administration fees deducted from members' accounts, investment fees and indirect costs but would not include transaction/activity fees.

Insurance premiums would not be included.

For lifecycle MySuper products, an appropriate metric would be to calculate fees and costs with respect to each lifecycle stage, and require a particular proportion of the stages to meet the benchmark.

2.1. Potential issues when assessing fees and costs

There are circumstances where some or all of the costs of administering members' insured benefits, instead of being recovered through fees charged directly to members, are incorporated in the insurance premiums charged to members. For such cases, as insurance premiums are not being included in the assessment, it would be necessary to determine an approximate amount of 'administration fee' with respect to insurance and include this in the final amount of fees and costs.

The final amount of fees and costs should be net of tax. As disclosed fees can be grossed up to include the effect of tax, care would need to be taken with respect to this.

2.2. Fees and costs assessment

A product with fees and costs that exceed the benchmark would be considered a 'relatively high-cost product' and would be assessed under stage 2.

3. Stage 2: Investment returns

Under Stage 2, where a MySuper product has not passed Stage 1, its net investment returns would be assessed and benchmarked.

The criteria for assessing and benchmarking investment performance would need to account for products that have existed for different periods of time, where the duration of time series data for investment returns differs across products.

To assess investment performance, ASFA suggests that average risk-adjusted net returns would be calculated for all MySuper products.

3.1. Risk-adjusted returns

Average (risk-adjusted) net returns would be calculated for all MySuper products. **Those with average (risk-adjusted) net returns in the lowest quartile would be considered to not have met the Stage 2 benchmark.**

In the absence of a long time series, a meaningful comparison of investment performance across products requires product returns to be adjusted for risk.

There are numerous methods for adjusting returns for risk, and each method has their pros and cons. Performance assessments could be undertaken using any one of these risk-adjustment methods and would be used to identify those products that fall into the bottom quartile of investment return performance.

ASFA suggests that average (risk-adjusted) net returns would be calculated for the last seven financial years, which would introduce a source of standardisation in assessment. For products with less than seven years of returns history, average (risk-adjusted) net returns would be calculated using the available data.

A particular challenge arises with respect to lifecycle products. One potential approach would be to calculate average (risk-adjusted) net returns with respect to each lifecycle stage, and require a particular proportion of the stages to meet the benchmark.

3.2. Other factors to consider in benchmarking and assessment

In undertaking an assessment of a MySuper product's investment performance, due consideration would need to be given to a range of factors that may affect investment performance. These include:

- whether there were material changes in the investment strategy/asset allocation during the assessment period.
- whether there were any significant market corrections or shocks.
- whether there had been a recession, financial crisis or depression.
- the presence of any material extrinsic factors and idiosyncratic risk which affected returns, such as a change to the tax treatment of particular assets or a material change in the cost of investing.

4. Outcome of the one-off performance assessment

A product with relatively high fees and costs (as determined under the Stage 1 assessment) that has average (risk-adjusted) net returns in the lowest quartile (as determined under the Stage 2 Assessment) would be considered to be a prima facie 'underperforming product'.

For underperforming products there would be an opportunity to state its 'Case to Remain' to APRA – if unsuccessful its MySuper authorisation would be revoked.

5. Underperforming products: Opportunity to state 'Case to Remain'

For underperforming MySuper products there would be an opportunity to state its case to APRA as to why its MySuper authorisation should be retained – if unsuccessful its MySuper authorisation would be revoked.

If the 'Holding Funds to Account' assessment is adopted on an ongoing basis, ASFA submits that it should be accompanied by this 'Case to Remain' mechanism.

ASFA suggests that the 'Case to Remain' process would focus on whether the best interests of members are being promoted overall. This approach would be broader, more holistic and more equitable than reliance solely on benchmarking fees and costs and net investment return performance.

There would need to be flexibility to look forward (not just backwards) and to take account of idiosyncratic risk. The 'Case to Remain' process would enable consideration of qualitative aspects, in addition to quantitative measures, such as the quality and value of insurance and advice, and could examine inputs as well as outputs. The process could address the issue of how to assess products that have materially changed their investment strategy or fee structure, in a way that a focus solely on past fees and costs and investment performance would not be able to do.

Ultimately APRA would be the decision-maker as to whether the MySuper product's response during the 'Case to Remain' process was sufficient to retain its MySuper authorisation.

5.1. Trustee to state its 'Case to Remain'

If a MySuper product does not meet the fees and costs and investment return benchmarks the trustee would, within a specified period, be able to state its 'Case to Remain' to APRA. There are a number of potential indicative factors that could be addressed by the trustees and taken into account by APRA in its assessment, as outlined on the following page.

5.2. APRA to assess trustee’s ‘Case to Remain’

APRA would have a specified period to have regard to the trustee’s ‘Case to Remain’ to determine whether the trustee should retain its MySuper authorisation.

Specific matters that APRA could take into account include:

- **Shorter-term net investment performance** – while a MySuper product may have experienced low returns in the early part of the assessment period, recent performance may have been strong. APRA could have regard to the fact that the MySuper product has revamped its investment governance to turn around its investment performance and that this is likely to continue to be reflected in improved investment performance.

- **Consideration of investment governance processes** – where a MySuper product does not meet the investment return benchmark this measure could be used, on a case-by-case basis, to determine whether there was a systemic, underlying issue that has been, or is capable of being, rectified.

- **Quality of broader governance and risk/compliance management** – where the trustee has enhanced its governance, risk or compliance framework/management, which is likely to result in improved performance.

- **Provision of, and investment in, member services, including advice** – this could help account for funds that have higher fees and costs but, in return, provide a higher quality or level of service and benefits, such as financial advice, IT applications or member information seminars, or where the trustee has invested additional expenditure on product or service innovation.

6. Outcome of the 'Case to Remain' exercise

APRA would determine, on balance, and having regard to any mitigating circumstances, whether:

- the MySuper product could be considered to be delivering appropriate outcomes to members
- the MySuper product could not be considered to be delivering appropriate outcomes at present but there is potential for rectification, or
- it is not feasible to rectify the MySuper product.

For MySuper products which are considered to be delivering appropriate outcomes to members there would be no need for further action.

If APRA determines that rectification may be possible it would work with the trustee to determine:

- the size/scope of a rectification/remediation plan to be put in place by the trustee
- specific courses of actions to be taken by the trustee to improve the product's performance
- the timeline for any trustee action
- the budget for rectification
- expected outcomes from the rectification plan

> For a MySuper product where:
>
> 1. the trustee does not meet the requirements under its rectification plan (in a material way); or
> 2. it is not feasible to rectify the MySuper product
>
> the trustee's authorisation to offer a MySuper product would be revoked.

7. Revocation of MySuper authorisation – need for a transition mechanism

It is critical that the Government and APRA work with the industry to develop an appropriate and transparent mechanism/process to ensure that members and assets are transitioned to a new MySuper product in an orderly manner and investments are dealt with appropriately. This could involve the appointment of an acting trustee and third parties being involved in developing, documenting and overseeing the transition process.

The major risk faced in such an exercise is with respect to underperforming investments. It may not be appropriate to expect a well-performing fund to acquire such assets to the disadvantage of their existing members and forced selling may crystallise losses during what could amount to a ‘fire sale’.

ASFA would be willing and able to work with the Government, APRA and its member organisations to develop an appropriate and transparent transition mechanism. ASFA considers that developing a transition mechanism needs to occur as soon as possible and well before APRA revokes a MySuper authorisation.

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system, so all Australians can enjoy a comfortable and dignified retirement. We focus on the issues that affect the entire Australian superannuation system and its $2.7 trillion in retirement savings.

Our membership is across all parts of the industry, including corporate, public sector, industry and retail superannuation funds, and associated service providers, representing nearly 90 per cent of the 16 million Australians with superannuation.

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