# SUBMISSION

# Submission to Treasury — Review of Your Future, Your Super Measures: consultation paper

14 October 2022

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Retirement, Advice and Investment Division
Treasury
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Via email: superannuation@treasury.gov.au

14 October 2022

Dear Sir/Madam,

**Consultation Paper on the Review of Your Future, Your Super Measures**

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission in response to your Consultation Paper on the *Review of Your Future, Your Super Measures,* released on 7 September 2022.

**ABOUT ASFA**

ASFA is a nonprofit, non-partisan 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 $3.3 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 over 90 per cent of the 17 million Australians with superannuation.

**GENERAL COMMENTS**

ASFA supports the objective of ensuring the good governance of superannuation funds and addressing product underperformance.

It is important, however, that the assessment of the performance of Australian superannuation products, and the consequences of underperformance, are appropriate.

Importantly, the effect of the Your Future Your Super measures on the outcomes of members should be assessed, to ensure that the out workings of the measures have been in the best financial interests of superannuation fund members.

**Performance test and consequences of failure**

The current performance test (**Test**) is a relatively simple measure of investment performance.

Given the consequences of failure of the Test are so significant, we recommend that

- the Test should be a more comprehensive assessment of investment performance, incorporating multiple metrics, which would be more accurate than the current single measure of net investment performance
- for a product that has failed the Test by a specified margin, the consequences should be either more intense scrutiny by APRA and/or an opportunity to 'show cause' to APRA as to why it should continue to be treated as if the product were performing.

**Barriers to consolidation/mergers of products**

Further, given the consequences of failure of the Test and the policy intent to see underperforming products close and consolidate with other products, there is a need to address barriers to consolidation and mergers of products.

One of the most significant impediments to product consolidation is that, while the transfer of all of the members' benefits from a transferring fund to a successor fund, with the transferring fund terminating, is eligible for relief from capital gains tax, there is no equivalent loss or asset rollover relief with respect to the transfer of a sub-set of members' benefits, in a partial transfer, with the fund remaining on foot.

Given this, we recommend that capital gains tax relief should also be provided in the event of a partial transfer of members' benefits, to facilitate the consolidation and merger of products.

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If you have any queries or comments in relation to the content of our submission, please contact me on (03) 9225 4021 or by email to fgalbraith@superannuation.asn.au.

Yours sincerely

Fiona Galbraith

Director, Policy

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## 2. Performance Test

The Consultation Paper (**Paper**) states that the Your Future Your Super performance test (**Test**) would "hold… trustees to account for the investment performance they deliver and the fees they charge to members" and "improve performance and accountability of funds", with "its objectives: to increase accountability and transparency of product performance".

The Test was developed in response to the Productivity Commission review recommendation that measures are needed to remove *persistently underperforming products* in order to improve outcomes for members of those products (emphasis added).[1]

The Paper states that "The [T]est is intended to improve outcomes for members by:

- ensuring that members do not join *persistently underperforming products*
- providing members with *information to choose better performing products*
- encouraging *underperforming products to improve their performance*, including through potential mergers".

ASFA supports the need for an objective benchmarking test.

It is critical, however, that any test be 'fit for purpose' and measure the products' investment performance accurately and appropriately.

In particular, especially given the significance of the consequences of failing the test, we consider that there needs to be

- absolute clarity and precision with respect to what is means for a product to be considered to be 'underperforming'
- a performance test that provides an accurate measure as to performance
- an approach that safeguards against the risk of 'false positives' i.e. products that 'fail' the test and yet can be considered to be performing.

### 1.1 Test methodology

**Benchmark portfolio approach is too simple – especially for a 'bright line' / 'line in the sand' test**

Importantly, the Test methodology is stated to assess a product's

- net investment returns against an objective benchmark portfolio tailored to its investment strategy; and
- its administration fees against its peers.

There are some issues with the test methodology adopted, but the most significant one is that the Test only measures investment performance in terms of how effectively/efficiently the trustee has invested against its investment strategy - it does not measure or assess the *performance of the investment strategy itself*.

**Test does not assess the product's strategic / tactical asset allocation**

The Productivity Commission review recommended using a benchmark portfolio to assess investment performance with the aim to account for the many influences on investment markets which are beyond funds' control, while providing insights into the value added by funds.[2]

Arguably the most significant value added by funds is through its strategic / tactical asset allocation, yet while the strategic asset allocation is utilised by the Test, it is not measured or assessed by the Test.

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[1] Productivity Commission, Review of Superannuation: Assessing Efficiency and Competitiveness No. 91, 21 December 2018 https://www.pc.gov.au/inquiries/completed/superannuation/assessment/report/superannuation-assessment.pdf

[2] Productivity Commission, op. cit., page 111

One product could be significantly weighted towards more conservative, less risky, less volatile defensive assets while another could be weighted towards less conservative, higher risk, more volatile growth assets. Generally the former is more likely to pass the Test than the latter, but is also more likely to produce lower investment returns over the medium to long term.

The result of the Test simply reflects the extent to which the trustee's investment in/divestment of specific assets has contributed to the product's investment performance, relative to the investment performance of the index for that class/type of asset that forms the benchmark.

Generally it is considered that it is the trustee's investment strategy with respect to strategic and tactical asset allocation - the exposure to the different classes/types of assets and the relative movement of different markets, more so than the selection of specific assets – that is the most significant determinant of investment performance. The Test does not assess the product's strategic or tactical asset allocation.

**Member outcomes are a function of the net (of taxes and fees) investment returns credited to benefits**

Member outcomes are the result of the *actual net (of tax and fees) investment return credited to their superannuation account.*

The Test does not assess this in either absolute or peer relative terms – only in comparison with the returns of the various indices comprising the benchmark portfolio.

This clearest illustration of this is that in 2021 there were MySuper products that failed the Test, yet their net investment return over seven years was higher, and their administration fee lower, than other MySuper products that passed the Test.

By way of illustration, the 2021 Test with respect to MySuper products produced the following results for three MySuper products:

| | MySuper Product 1* | MySuper Product 2* | MySuper Product 3* |
|---|---|---|---|
| **Outcome of Test** | Underperforming | Underperforming | Performing |
| **7 year net return** | 7.49% | 7.16% | 7.03% |
| **5 year net return** | 8.16% | 7.78% | 7.27% |
| **3 year net return** | 7.67% | 7.81% | 6.53% |
| **Total annual fee** | $577 | $610 | $610 |

* The names of the products can be provided on request.

From this it can be seen that, when comparing the three funds (the first with a lower admin fee and the second and third with identical admin fees):

- the third product – with lower net investment returns over seven, five and three years than the first two products, and the same admin fee as the second product/higher admin fee than the first product - was determined to be performing
- the first two products – with higher seven, five and three year net returns than the third product, one with the same admin fee and one with a lower admin fee than the third product - were assessed to be underperforming.

**Test does not incorporate most risk adjusted improvements from diversified exposures**

Trustees often develop strategies designed to reduce or mitigate market risk, including diversification and the use of derivatives and overlays. Choice products in particular will have a range of risk profiles to meet the various needs of different members.

Notwithstanding this, in assessing performance the Test does not take risk adjusted returns into consideration.

**Test does not incorporate the investment objectives of the product**

While the investment objective of MySuper products should be broadly comparable, nevertheless, as a result of differences in the demographics of the membership base – in particular age and size of account balance – there may be justifiable differences, as exemplified by lifecycle MySuper products.

This will be even more of an issue when it comes to choice products, as these have a broader range of investment objectives, yet the Test does not take these into consideration.

**Test is backwards looking and inconsistent with consumer disclosure**

ASIC has a Regulatory Guide devoted to the use and disclosure of past performance – *Regulatory Guide 53: The use of past performance in promotional material* – that addresses the issue of good past performance being an unreliable predictor of future good performance over the medium to long term.

In line with this, providers of financial investment products are required to issue consumer warnings to the effect that 'past performance is not a reliable indicator of future performance'.[3]

There were two MySuper products in 2021 with an identical future investment strategy - one passed the Test and the other failed. Obviously investment performance can only be assessed in arears, however, this serves to reinforce that the Test is not about future member outcomes but instead about past performance. Given this, it is imperative that a product that has failed the test by a specified margin have the ability to 'show cause' as to why it should continue to be treated as a performing product.

**Test methodology is not achieving its objective**

ASFA is of the view that the Test methodology is not achieving its objective of accurately and comprehensively measuring performance.

This is of particular concern, given the 'bright light' / 'line in the sand' nature of the test and the severity of the consequences of failure.

## 1.2 Effect of the Test on trustee behaviour

Trustees need to make investment decisions at different levels:

- strategic asset allocation to various asset types / classes / markets – e.g. Australian equities; overseas equities; Australian bonds; overseas bonds – this can be either static or dynamic
- tactical asset allocation within each asset types / classes / markets – e.g. overweighting finance shares and underweighting resource shares
- specific asset selection within each asset types / classes / markets – e.g. overweighting BHP and underweighting Rio Tinto
- the extent to which derivatives and overlays should be utilised to mitigate risk.

The Test utilises the product's strategic asset allocation to determine the portfolio benchmark.

**Tactical asset allocation and specific asset allocation**

When it comes to both tactical asset allocation and specific asset selection, however, decisions made by the trustee will mean that the product's investment performance will vary from the index.

Arguably the most significant value added by funds is through its strategic and tactical asset allocation.

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[3] ASIC Regulatory Guide 53, page 9 https://download.asic.gov.au/media/1238984/rg53.pdf

The Test is likely to alter the investment behaviour of super funds, with respect to the composition of their portfolio, as it incentivises trustees to attempt to replicate, as much as possible, the asset class indexes, to minimise the risk that an adverse investment outcome would result in the product failing the Test.

Given the consequences of failing the Test, the methodology of the test means that, when determining its tactical asset allocation and selecting assets, trustees will be less inclined to deviate significantly from the relevant index and more inclined to 'track' to it, even though this may produce a lower return over the medium to long term. This is exacerbated by the extent to which the assets in the indices are a sub-set of the available universe of assets and/or differ from the current asset allocations of Australian super funds.

As the strategic asset allocation is used when constructing the product's portfolio benchmark, trustees may be inclined to set more conservative allocations, which over the medium to longer term are likely to produce lower returns. Consideration could be given to using the product's tactical asset allocation as a slightly more accurate measure.

**Limitations with the use of indices**

The limitations around unlisted benchmarks are endemic and understood, and mean they are not always an appropriate basis for assessing investment performance.

The investment performance of a superannuation product with a portfolio of infrastructure assets will reflect the performance of the underlying assets, however, the portfolio will have a smaller number of assets, and be less diversified, than those of an infrastructure index constructed across different asset types and geographic locations.

Similar issues can arise with respect to other types of unlisted assets, such as unlisted property, and investments in private equity and venture capital.

The composition of the benchmark necessarily reflects the stock of existing infrastructure assets and, as such, the benchmark encourages products to have a similar asset allocation in order to minimise tracking error. If, for example, a product wanted to increase exposure to renewables, and thereby go over-weight relative to the benchmark, this represents an additional source of risk for the product's investment performance.

The means that the benchmark can act as a constraint on investment decisions, even where the expected long-run returns are favourable.

Further to this, unlisted infrastructure assets, such as airports and toll-roads, are subject to a variety of idiosyncratic risks that can negatively affect the investment outcomes for that asset. This is problematic, as a single infrastructure asset is likely to have a disproportionate effect on the investment performance of a super product's unlisted infrastructure assets when compared with the index, and so there is a risk that funds will eschew unlisted infrastructure assets in favour of other assets.

Overall, it is likely the Test will result in the value of fund investments in unlisted assets being less than otherwise would be the case.

**Need for alternate indices for unlisted investments**

There is a need to examine the possibility of using additional/alternate benchmarks for unlisted assets.

When it comes to unlisted infrastructure, it is considered that a listed index would not be an appropriate benchmark. Use of such an index can have the effect of incentivising funds to build portfolios that are less diversified and higher risk, with a consequential detrimental effect on investment in Australian infrastructure and other sectors that deliver critical services and support economic growth.

Other indices may not accurately reflect the performance of typical unlisted infrastructure portfolios that are held long term by Australian superannuation funds.

These indices can be idiosyncratic, with key inputs being infrequent and incomplete secondary market transaction pricing and outputs, based upon opaque statistical modelling and machine learning. Furthermore, they can be biased towards other jurisdictions and their volatility can be more akin to that of listed markets, as opposed to the relatively stable risk-return characteristics of unlisted infrastructure.

With respect to unlisted infrastructure investment, one possible alternate benchmark could be the *MSCI Australia Quarterly Private Infrastructure Index (Unfrozen) - Post-fee Total Return (All funds)* (the "MSCI Index"). Currently the MSCI Index comprises most major Australian domestic infrastructure funds, providing diverse asset exposure.

The MSCI Index, however, has relatively little exposure to renewables and other infrastructure emphasising climate solutions. As a result, funds seeking to contribute to decarbonisation and protect the long term resilience of investment markets will likely need to take significant basis risk in order to do so.

Give this, we would support the introduction of a renewables or green energy benchmark that could capture the distinctive attributes of the renewables asset class.

**Tracking error**

The issue of tracking error persists across a number asset classes, not just unlisted assets.

By way of example, the fixed income benchmark does not account for floating rate investments and serves to create the risk of tracking errors.

Given this, this raises concern both with respect to the accuracy of the Test and the potential effect on investor behaviour.

**Use of derivatives and overlays to mitigate risk**

Furthermore, and importantly, the Test does not take into consideration where the trustee has developed strategies designed to reduce or mitigate market risk, including the use of derivatives and overlays.

This is likely to lead to the trustee needing to reduce their use of such strategies, resulting in a higher level of risk, which may not be in the best interests of members. In effect, the Test captures the cost of risk-mitigation, but not the benefits.

### 1.3 Difficulties with communicating Test results to members

One of the stated aims of the Test is to increase accountability and transparency of product performance by providing members with information to choose better performing products.

The experience of our member funds is that generally members do not understand what the Test means.

Members understanding of the Test is one of the keys to enabling them to achieve improved outcomes, however, other than the simplistic label of 'performing' or 'underperforming', trustees have found it challenging to communicate to members what the test is and what it means. This is particularly the case where a product has failed the test and yet has delivered relatively high net investment returns, especially in recent periods and/or when compared with other products.

### 1.4 Technical issues with the Test

We are conscious that the Government has established a Technical Working Group to provide constructive, solutions-based discussions on specific technical issues relating to the Test.

Given this, we have just flagged some of the technical issues with the Test.

**Issues with the current Test**

Some of the technical issues with the current Test include:

- utilisation of eight years of investment performance returns - given super is a long term investment, we recommend performance be measured over a ten year period
- there is a need for more asset classes / indices, such as, for example, for emerging markets; large caps and small caps etc
- it does not cater for 'values based' or 'principles-based' investment options, including ethical investment products, products that employ strong Environmental, Social and Governance (ESG) filters and products that otherwise focus on sustainability
- use of the target asset allocation, as opposed to the actual asset allocation
- failure is 50 basis points below the benchmark – with any 'line in the sand' test such as this the determination of where the line should fall is, by its very nature, arbitrary. It is arguable that a product 49 basis points below the benchmark in any given year is not materially more likely to outperform a similar product 50 basis points below, yet the latter product fails the Test, with significant consequences, while the former passes the Test.

**Recommendation 1**

**Period of measurement should be longer**

- Performance should be measured over a minimum of a ten-year period

**Recommendation 2**

**Need for more asset classes**

- There should be more asset classes/indices, such as emerging markets, large caps and small caps

**Recommendation 3**

**Appropriate benchmarks**

- Given products invest in a variety of asset classes for diversification and risk-reduction, it is critical that the Test uses appropriate benchmarks

### 1.5 Need to refine Test methodology and assess whether consequences are appropriate

Given the issues with the Test outlined above, and the significance of the consequences for failing the Test, we are of the view that there is a need to

- refine the Test methodology to more accurately measure the effect of risk-adjusted product investment performance on member outcomes; and
- given the nature of the Test - examine whether the consequences of failure are appropriate.

**Recommendation 4**

**Test methodology should be more comprehensive**

- The Test methodology should be refined to be a more comprehensive assessment, incorporating multiple metrics, including assessing the trustee's asset allocation

### 1.6 Consequences of failure are inappropriate, given the limitations of the Test

The paper states that "[t]he performance measure is used to identify persistent underperformers so that consequences can be applied that hold trustees to account for underperformance and increase transparency for members".

As per above, ASFA has concerns that the Test is not an accurate measure of persistent underperformance or indicator of future member outcomes.

Given the limitations of the Test – in particular that it only measures one metric of investment performance, with a somewhat arbitrary, 'line in the sand' – we consider that the consequences of failure of the Test are too severe.

It is imperative that superannuation products are not assessed solely on the basis of the Test but instead there is a more nuanced approach to a product that has failed the Test.

There are a couple of potential approaches that could eb adopted with respect to products that have failed the Test by a specified margin:

- the trustee/product is subject to more intense supervision by APRA and/or
- the trustee should be able to apply to APRA to 'show cause' as to why the product should be considered to be performing.

In addition to a 'line in the sand' test, there is a need for qualitative oversight and consideration of matters that may affect future member outcomes. This could include an assessment of such matters as the effect of investment cycles and exogenous events on investment performance, that would necessitate expertise and the exercise of judgement.

**More intense supervision by APRA**

This could take the form of close continuous monitoring, an exchange of letters or other measures.

**Trustee able to 'show cause'**

The trustee of a product that has failed the test by a specified margin would be able to 'show cause' to APRA as to why the product should continue to be considered to be performing.

APRA would evaluate whether the product has, or is likely to, deliver appropriate member outcomes in the medium term. If APRA has not determined that the product is underperforming within a specified period the product would be deemed to be performing.

**Recommendation 5**

**Consequences of failure – ability to 'show cause'**

- A trustee of a product that has failed the Test by a specified margin should be able to 'show cause' as to why the product should continue to be considered to be performing.

**Matters to be considered could be prescribed in regulations**

The matters to which APRA would have regard when assessing the trustee's 'show cause' application could be prescribed in the regulations and could include:

- recent short-term net investment performance
    - a product may have had poor performance in the early part of the assessment period, which dragged down its longer term average, but recent performance could be strong
    - poor performance is attributable to investment cycles or to an exogenous event such as, for example, the disruption to investment markets or to the value of certain asset(s), for example as may have been caused by COVID 19
- recent reduction in fees charged to members – the trustee may have reduced fees charged to members in recent times, which will improve member outcomes going forward
- changes in structure or business operating model – there may have been a material change in the structure of the fund, or its business operating model, which will improve investment performance and/or member outcomes in future
- improvements in investment governance processes – the trustee may have effected changes to its investment management framework that have improved the investment performance of the product, that is likely to continue
- improvements in broader governance and/or risk or compliance management – a trustee may have experienced governance, risk or compliance issues but has taken action, such as replacing directors and/or key risk or compliance personnel; implementing material improvements to its governance framework; enhancing its risk management and compliance framework; or introducing or improving processes
- quality and value of insurance – regard could be had to the quality and value of the product's insurance offering, including cover tailored to its members and the payout to premium ratio of the insurance offering
- provision of, and investment in, member services, including advice – this could help account for products that have higher fees but in return provide a higher level or quality of services and benefits, such as financial advice or IT applications, that are appropriate for their members, or where the trustee has invested additional expenditure in product or service innovation during the assessment period.

## 1.7 Issues with current consequences – letters and not accepting new members

**First failure – letters sent to members**

There are a number of issues with respect to the letters sent to members on the first failure of the Test:

- there appears to have been a lack of member engagement with the letters
- with those members who did engage, from anecdotal evidence about 'phone calls to funds, there was considerable confusion about how/why the MySuper product was considered to be underperforming and what this meant for the member
- there is no reference to the possible loss of insurance if the member moves from the product
- there are particular issues with respect to funds that are undergoing mergers:
    - the wording is prescribed and the trustee is unable to amend the text
    - there were instances where letters had to be sent to members just prior to the Significant Event Notice (SEN) with respect to the Successor Fund Transfer (SFT) – this made it confusing for members and difficult for them to figure out what was in their best interests

- given this, ASFA recommends that either
    - if the fund has a signed a MOU/heads of agreement document and the SEN is going to be sent within a prescribed period - the trustee should be exempted from sending the letter; or
    - if the letter must still be sent - to assist with members' understanding, trustees should be permitted to tailor it to refer to the pending SFT.

**Recommendation 6**

**Consequences of failure – fund undergoing merger**

- If the fund has a signed a MOU/heads of agreement document and the SEN is going to be sent within a prescribed period - the trustee should be exempted from sending the letter; or
- If the letter must still be sent - to assist with members' understanding, trustees should be permitted to tailor it to refer to the pending SFT

**Second consecutive failure – difficult to improve returns quickly**

It is extremely difficult to improve investment returns in the year between the first and second test.

As a result of this, given the consequences of failing the second test and not being able to accept new members, effectively creating a legacy product, most potentially failing funds looked to merge. Mergers, however, tend to be multi-year projects and so there is a likelihood that it will not be completed when the second test is failed.

**Second consecutive failure – cannot accept new members**

Approaching the second Test there can be considerable uncertainty as to the likelihood that the product will pass the Test a second time.

Given the consequence of a second consecutive failure - not being able to accept new member - has immediate effect, a trustee that potentially may fail the Test a second time is compelled to develop comprehensive contingency plans to address this eventuality. This can prove to be resource intensive and yet, should the product pass, redundant – none of these costs can be recouped.

Accordingly, ASFA recommends that the consequence of failing the Test a second consecutive time has effect from three months after the publication of the Test results.

**Recommendation 7**

**Second consecutive failure – cannot accept new members**

- The consequence of failing the Test a second consecutive time should have effect from three months after the publication of the Test results

If the product is unable to accept new members this will have the effect of creating a legacy product with a decreasing pool of members, which will have a deleterious effect on scale, especially when it comes to investments and insurance.

### 1.8 Barriers to consolidation/mergers of products

Further, given the consequences of failure of the Test and the policy intent to see underperforming products close and consolidate with other products, there is a need to address barriers to consolidation and merger of products.

One of the most significant impediments to product consolidation is that, while the transfer of all of the members' benefits from a transferring fund to a successor fund, with the transferring fund terminating, is eligible for relief from capital gains tax, there is no equivalent loss or asset rollover relief with respect to the transfer of a sub-set of members' benefits, in a partial transfer, with the fund remaining on foot.

It is important to note in this context that there is a distinction between circumstances where:

- both the legal and beneficial ownership of an asset changes (which can be considered to be a 'true' CGT event); and
- only the legal ownership is transferred to another, leaving the beneficial ownership unchanged (which can be considered to be a 'notional' CGT event).

A consolidation or merger of products can be considered to fall into the second category, as the members retain the beneficial interest.

From the outset, the CGT tax has allowed rollover relief in circumstances where asset ownership changes were associated with specified types of business reorganisations, where no change occurred in the underlying ownership of the asset concerned or where the underlying assets against which the taxpayers had a claim did not change. This is commonly known as the business reorganisation rule.

Permitting the rollover of CGT gains/losses on product consolidation or mergers – where only the legal, and not the beneficial, ownership of the asset has changed – is entirely consistent with the business reorganisation rule. Arguably, the only reason that this did not occur at the time the CGT legislation came into existence in 1985 was the fact that superannuation was in its infancy and not considered.

Given this, we recommend that capital gains tax relief should also be provided in the event of a partial transfer of members' benefits, to facilitate the consolidation and merger of products.

| **Recommendation 8** |
| --- |
| **Barriers to consolidation/mergers of products** |
| • Capital gains tax relief should also be provided in the event of a partial transfer of members' benefits, to facilitate the consolidation and merger of products |

In some cases successive failures of the performance test may reduce the likelihood of a fund merging as the loss of members in response to the letter and the inability to accept new members reduces the appeal of the merging fund and impedes the best financial interests analysis of the potential successor fund.

The Productivity Commission noted that

> 'APRA may need to temporarily limit flows of money out of the affected fund to avoid a 'run' of members seeking to roll out balances all at once (which could disadvantage remaining members if assets were required to be sold quickly for liquidity reasons).'[4]

### 1.9 Product coverage

The Test is scheduled to be extended to choice products, specifically Trustee Directed Portfolios (**TDPs**), from 1 July 2023.

**Choice products often fulfil a specific purpose for members**

Choice products often have a specific objective, that has been disclosed to members and the reason why they have chosen that product.

[4] *Productivity Commission, op.cit, page 494*

By way of example, a choice product may have the objective of 'smoothing' returns, to provide a degree of certainty to members, through minimising the volatility of returns. This will mean that, while in bear market of weaker returns the product is likely to perform, in a bull market of stronger returns the product is likely to 'underperform' and will be at risk of failing the Test, notwithstanding that it is delivering against its objective - of smoothing returns – that the member has chosen.

**Consequence on choice products**

The current formulation of the Test is likely to have the effect of stifling innovation and customisation in the design of choice products.

Specialist investment strategies will perform differently to a market cap weighted portfolio – the more marked the difference the less likely the trustee will be to risk returns being less than the relevant indices and thereby failing the Test.

**Definition of Trustee Directed Products**

TDPs are multi-sector accumulation products where the trustee controls the design or implementation of the investment strategy.

The definition of TDP also includes where the trustee invests in a product offered by a 'connected entity'. This can include both 'arms' length' products, which are available for other trustees to offer on their platforms, and 'non arms' length' products, that are more in the way of an 'in house' product.

With the former the trustee has no control or influence over the design and implementation of the investment strategy of the product. Given this, that makes an 'arms' length' product more akin to an externally directed product, which are not included in the Test.

Accordingly, ASFA recommends that the definition of TDP not include 'arms' length' products where the trustee has no control or influence over the design and implementation of the investment strategy of the product.

**Recommendation 9**

**Definition of Trustee Directed Product**

- The definition of TDP should not include 'arms' length' products where the trustee has no control or influence over the design and implementation of the investment strategy of the product

**Extension to other products, including other choice products and retirement products**

Given the limitations of the current Test – that it does not take into account the objective or risk of the product – we would advocate that the Test not be extended further until this is rectified.

By way of example, choice products may have specific objectives, such as investing in accordance with ESG principles or preserving capital, that differ from purely seeking to maximise returns over the medium to long term. The Test methodology as it currently is designed is not applicable to these types of products.

When it comes to retirement products, the Retirement Income Covenant requires trustees to formulate a strategy to balance additional objectives for members who are approaching or in retirement, such as managing risks to the sustainability and stability of retirement income and providing a degree of certainty with respect to drawdowns. This makes retirement income products especially unsuited to the current formulation of the Test.

Given this, ASFA recommends that Treasury and the Government consult widely with respect to extending the Test to other products, and consider alternative approaches and the need for standardisation.

**Recommendation 10**

**Extension to other products**

- The Treasury and the Government consult widely with respect to extending the Test to other products, and consider alternative approaches and the need for standardisation

**Technical issues with the extension of the Test to choice products**

We are conscious that the Government has established a Technical Working Group to provide constructive, solutions-based discussions on specific technical issues relating to the Test.

Given this, we have simply flagged some of the technical issues with extending the Test to Wrap/Platform products, including

- investment returns are reported on a before tax basis, while the indices' returns are calculated on an after tax basis
- the tax treatment of investment options can be at either the member level or the option level – if the former it is not readily comparable against an index calculated on an after tax basis
- administration fees are determined on a 'whole of account' basis, but are reported for each investment option, resulting in double counting.

We would be happy to provide further details if necessary.

# 3. YourSuper Comparison Tool

The Productivity Commission recommended 'the need for a centralised online service that allows members to compare products and consolidate accounts'[5].

**Objective of YourSuper Comparison Tool**

We agree that the Comparison Tool (**Tool**) should look to improve member engagement by providing members with simple, clear and trusted information to help them to compare and choose a well-performing MySuper product.

There are, however, some impediments to achieving this objective. These include:

- the limitations of the Test – as per above the Test
  - only measures investment performance against a benchmark constructed through the use of indices applied the products strategic asset allocation. The Test does not assess the product's
    - strategic asset allocation
    - tactical asset allocation
    - use of strategies to mitigate risk, such as the use of derivatives and overlays
  - measures past performance, which is not an indicator of future performance
  - does not take into consideration the risk of the product
  - does not take into consideration the objectives of the product
  - does not assess the product's absolute or relative investment performance
- given the limitations of the Test, a member could choose a fund that is considered to be performing and yet will produce a worse outcome than another fund that is considered to be underperforming
- using the example provided above of the 2021 test result for three MySuper products – as at 30 June 2021, a member with a $100,000 balance as at 30 June 2014, receiving $10,000 in contributions each year, would have accumulated approximately, in today's dollars:
  - $235,000 if they had been in MySuper product 1 –an underperforming fund
  - $230,000 if they had been in MySuper product 3 –a performing fund
- the Tool does not disclose the insurance attached to the product, which is a material benefit for MySuper and a number of choice products
- the Tool does not communicate to members that
  - different products have different risks
  - that the benchmark against which the product has been measured is unique to that product and has been tailored to that product's strategic asset allocation.

  This means that products are not directly comparable – the Tool is more akin to comparing 'apples with oranges' than it is 'apples with apples'.

**Recommendation 11**

**Communication of risk**

- For each product the Tool should present either
  - risk adjusted net returns; or
  - a separate risk measure

[5] Productivity Commission, op. cit., page 301

**Display on YourSuper Comparison Tool**

Displaying fees, net returns and whether the product's investment performance is categorised as either 'performing' or 'underperforming' potentially is confusing to members, because

- 'investment performance' could be considered to be synonymous with 'net returns', yet the performance measure takes administration fees into account
- a product can have higher net returns than a 'performing' product and yet its 'investment performance' is 'underperforming'.

**Sorting of products**

Sorting MySuper products from lowest to highest fees by default places an undue emphasis on administration fees, as opposed to net investment return.

Given the importance of net investment returns, we recommend that MySuper products should be sorted by default from highest to lowest net returns.

**Recommendation 12**

**MySuper Comparison – sorting of products**

- MySuper products should be sorted by default from highest to lowest net returns

**Lack of warning re loss of insurance**

Given the authenticated version of the comparison tool can prompt members to consider consolidating accounts if they have more than one, and a member accessing the unauthenticated tool may be similarly minded to roll-over from their existing account, there should be a warning to the effect that rolling-over from an existing fund is likely to result in the loss of any insurance the member may have in that fund.

**Recommendation 13**

**Loss of insurance**

- The YourSuper Comparison tool should have a warning to the effect that rolling-over from an existing fund is likely to result in the loss of any insurance the member may have in that fund

**Link to MySuper Product Dashboard**

As the Paper notes, MySuper Product Dashboards provide additional information on performance, risk and fees, however, these metrics are not always consistent with the metrics reported in the comparison tool.

The first point to note is that the Your Super Comparison Tool does not contain a metric with respect to risk. This would be a useful metric for consumers to be aware of, however, significant work would need to be done to enhance to current risk measure to create a measure of risk that is meaningful to members.

With respect to investment performance, the MySuper Product Dashboard contains the product's return target, which is not taken into consideration in the Test and may be confusing for members.

Given that investment returns are reported net of fees and costs, and administration fees are reported separately, there is a risk of double-counting of administration fees.

**Potential extension to choice products**

The average super platform / wrap can have hundreds, and even thousands, of investment options.

The implications of this will need to be considered carefully, as there is a considerable risk this volume of data could become meaningless. Worse, being overwhelmed with data may encourage people to shift to a product with the lowest fees, even if it were cash, or cash-like, which would have a highly detrimental effect on their retirement outcome.

While the current, MySuper, version of the Tool is workable and, given the nature of MySuper relevant and meaningful, an equivalent toll for choice products will necessitate extensive consideration and consultation.

# 4. Stapling

**Members under 25 and hazardous occupations**

One potential unintended consequence of stapling is the interaction with the Putting Members' Interest First (PMIF) legislative amendments, which can mean that a member under 25 joining an employer in a hazardous occupation may be stapled to a fund/product under which, as a result of PMIF, they do not have any default insurance cover.

Default cover is especially important with respect to blue collar workers - for many workers in hazardous occupations either are unable to take out voluntary insurance cover or it would be much too expensive for them to do so.

Some funds have obtained a 'dangerous occupation' exception whereby they are able to offer default insurance cover to members under age 25. Should the employee, on joining an employer in a hazardous occupation, be enrolled in the employer's default super fund with a 'dangerous occupation' exception in place they would be provided with default insurance cover, however, if they have a stapled fund this will not occur.

Given the nature of group insurance, the fact that a member is not insured is likely not to be known until the point in time at which a claim is made, which can be some years, or even decades, down the track. Accordingly, it will be difficult to ascertain the extent to which this may be an unintended consequence of stapling for some time.

Treasury and Government may like to consider this matter and consult with industry further about the ramifications of stapling on insurance.

**Members – underperforming funds**

Another issue of concern is that members can be 'stapled' to a fund that is considered to be underperforming.

We appreciate that this would not be a straightforward matter to resolve with respect to existing balances but consideration should be given to addressing this issue, at least with respect to members who change jobs and their future contributions. One possibility may be that, after a product has been determined to be underperforming, future 'staple requests' with respect to a new employee would return a null result if their stapled My Super product were underperforming, although this would prove difficult to extend to choice products.

**Members – choice form**

The ATO currently is reviewing the choice forms. We recommend that the ATO consult widely with stakeholders with respect to this, including with insurance specialists regarding disclosing to members the potential effects on members' insurance cover should they be stapled, exercise choice or be defaulted.

**Employers – onerous administrative burden**

Currently, the additional step for employers – to check with the ATO whether an employee has an existing ('stapled') super fund prior to making contributions to super – is onerous, as it necessitates the employer having to input employee details manually.

The only exception to this is where there are a 100 or more employees, where there is an option of performing a bulk upload of an excel spreadsheet, although this is still a relatively manual process.

Some employers have been compelled to employ additional FTEs to manage this process.

Given this, the rollout of the wholesale solution – to allow digital service providers to integrate stapling request functionality into their software and allow users to automatically request stapled fund information through their payroll system – is of critical importance.

**Employers – lack of information from government**

Employers have reported a general lack of education from government with respect to their obligations under the stapling regime.

The feedback received has been that the government did not put out a great deal of information with respect to stapling at the time of commencement of the regime and that it should look to raise awareness of stapling and to educate / assist employers with respect to their obligations.

# 5. Best Financial Interests Duty

**Reversal of the evidential burden of proof**

In a civil penalty proceeding the onus is on the trustee of a super fund to provide evidence that it performed its duties and exercised its powers in the best financial interests of the members.

Under the legislation it is presumed that a trustee did not perform its duties or exercise its powers in the best financial interests of beneficiaries, unless the trustee adduces evidence to the contrary.

As noted by the Standing Committee for the Scrutiny of Bills (Standing Committee) in Scrutiny Digest 5 of 2022[6], in a different context:

> *1.49 At common law, it is ordinarily the duty of the prosecution to prove all elements of an offence. This is an important aspect of the right to be presumed innocent until proven guilty. Provisions that reverse the burden of proof and require a defendant to disprove, or raise evidence to disprove, one or more elements of an offence, interfere with this common law right.*[7]
>
> *…..*
>
> *1.52 ….. the relevant test is that a matter should only be included in an offence-specific defence (as opposed to being specified as an element of the offence) where it is peculiarly within the knowledge of the defendant.*[8]
>
> *…..*
>
> *1.58 The committee considers it is not appropriate to reverse the evidential burden of proof in relation to matters that are not peculiarly within the knowledge of the defendant".*

In ASFA's view there is no justification for the reversal of the evidential burden of proof.

Most importantly in this context, superannuation funds are regulated and supervised by APRA and ASIC and the regulators are able to request, or even demand, the production of documents during the course of that supervision.

Accordingly, it is neither necessary nor reasonable to reverse the evidential burden of proof - it is manifestly inappropriate to presume, legally, that a trustee did not perform its duties or exercise its powers in accordance with the best interests duty.

| **Recommendation 14** |
| --- |
| **Reversal of the evidential burden of proof** |
| • There is not sufficient justification for the reversal of the evidential burden of proof, so the burden of proof should remain with the regulator and the legislation should be amended accordingly |

**Policies and procedures – evidence**

The Paper observes that anecdotal evidence suggests some trustees have been putting in place a wide range of approaches to respond to the duty, especially in the context of recording compliance, while other experiences indicate trustees have a lack of clarity in how to record compliance.

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[6] *Standing Committee for the Scrutiny of Bills (Standing Committee), Scrutiny Digest 5 of 2022, Page 16*

[7] *44 Attorney-General's Department, A Guide to Framing Commonwealth Offences, Infringement Notices and Enforcement Powers, September 2011, pp. 50–52.*

[8] *46 Attorney-General's Department, A Guide to Framing Commonwealth Offences, Infringement Notices and Enforcement Powers, September 2011, p. 50.*

The best financial interests duty is a principle and not prescriptive in nature. Given that how a trustee is to perform its duties and exercise its powers is not a prescriptive regime, it is difficult to simply 'record compliance'.

The basis on which a trustee exercises its powers with respect to expenditure will vary with the nature and be commensurate with the amount of the expenditure.

The Paper states the basis on which a trustee can make a decision may include a business case, including quantification of expected outcomes, cost–benefit analysis, statement of risks and mitigation strategy.

While this may be appropriate for significant programme/project expenditure, it would be overkill with respect to 'day to day', operational expenditure, which can be for significantly lesser amounts. Trustees generally have approached the matter of 'day to day', operational expenditure through the development of policies (for example travel policies) that they consider, if adhered to, will means that expenses incurred while running the super fund will be reasonable and appropriate.

Evidencing that expenditure is in the best financial interests of members is likely to continue to be a substantial ongoing burden for cost centre managers and procurement/finance teams.

Depending on the policies and procedures in place, expenditure can necessitate the development and review of 'business cases', as well as the on-going monitoring and review of all outlays. This can mean that considerable staff resources are being expended in reviewing and justifying immaterial expenditure, the cost of which ultimately is borne by the members, to the detriment of member outcomes.

Furthermore, the lack of guidance, beyond a few limited examples, is likely to have resulted in policies and procedures being implemented inconsistently across the industry.

Given the reversal of the evidential burden of proof, the uncertainty surrounding what evidence is required regarding the validity of expenditure (other than major programmes/projects), and the likelihood of inconsistent approaches across the industry, it is imperative that APRA provide guidance to clarify and explain what evidence is required for different types and amounts of expenditure.

**Recommendation 15**

**Policies and procedures – evidence**

- APRA should provide guidance to clarify and explain what it, as regulator, considers to be the minimum level of evidence required for different types and amounts of expenditure

**Alignment with SPS 515 – Strategic and Business Planning**

ASFA recommends that, in developing guidance with respect to the requirement to support and evidence expenditure decisions, APRA look to aligning the guidance with the requirements with respect to robust analysis for significant expenditure as outlined in *SPS 515 Strategic and Business Planning.*[9]

Where guidance is especially required, however, is with respect to day to day operational expenses.

**Recommendation 16**

**Alignment with SPS 515 – Strategic and Business Planning**

- In developing guidance APRA should look to aligning the guidance with the requirements with respect to significant expenditure in *SPS 515*

[9] *SPS 515 Strategic and Business Planning, page 12, paragraph 46 ff,* https://www.apra.gov.au/sites/default/files/prudential_practice_guide_spg_515_strategic_and_business_planning_august_2019.pdf

### Materiality

Should any concept of materiality be considered ASFA strongly recommends that this be done as a proportion of the funds' assets under management and not as a fixed dollar amount, as:

- the effect of expenditure on member outcomes generally is a function of the proportion of member benefits that it represents, as opposed to the absolute value of the expenditure
- proportions will change automatically over time, in line with the change in funds under management, whereas any dollar value would need to be indexed to keep pace with inflation.

**Recommendation 17**

**Materiality**

- If materiality is considered, this be done as a proportion of the funds' assets under management and not as a fixed dollar amount