Your Future, Your Super Review

Consultation Paper – FSC Submission

October 2022

Contents

1. About the Financial Services Council

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advice licensees. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing more than $3 trillion on behalf of over 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is one of the largest pools of managed funds in the world.

The FSC's mission is to assist our members achieve the following outcomes for Australians:

- to increase their financial security and wellbeing;
- to protect their livelihoods;
- to provide them with a comfortable retirement;
- to champion integrity, ethics and social responsibility in financial services; and
- to advocate for financial literacy and inclusion.

We do this by continuously engaging in advocacy concerning the development of the social, economic and regulatory framework in which our members operate, thereby helping them to better serve their clients and customers.

2. FSC Recommendations

1. Maintain the current performance test approach to the calculation of actual return. Any increases to the lookback period of eight (8- years) to say ten (10-) years should only be done by incorporating new investment performance experience over time.
2. Include additional indices to account for the most significant variations in risk-return profiles of investments within the equity, fixed interest and 'other' asset classes.

   Our specific recommendations and suggested indices are set out in the table from Page 9 of this submission.

3. Improve the Australian Unlisted Infrastructure Index to ensure it meets a commonly accepted market benchmark and reflects a natural investable universe.

4. Consider transitioning to international indices for international asset classes that currently utilise Australian indices (International Unlisted Property and International Unlisted Infrastructure).

5. Maintain the current approach to the calculation of actual RAFE and benchmark RAFE for MySuper products.

6. Revise content of member communications to ensure that appropriate considerations for members changing products or funds are clearly listed, including potential impacts on insurance coverage.

7. Maintain the consequence management framework for MySuper products.

8. Facilitate product modernisation in superannuation triggered by the Your Future, Your Super reforms, by extending the capital gains tax rollover relief for mergers of superannuation funds to additionally include the transfer of superannuation products within a fund.

9. Ensure the exclusion of single sector products and retirement products within the Trustee Directed Product definition operates as intended.

10. Clarify the application of the Trustee Directed Product definition to ensure investment options where the trustee has no control or influence over the investment strategy consistent treatment with externally-directed products (including where the investment option is issued by a connected entity)

11. Make clear that there is no intent to extend the existing benchmark performance test approach to Trustee-Directed Products and other Choice products.

12. Undertake further consultation to determine the most appropriate approach and implementation timeframe for introducing performance testing for Trustee-Directed products.

    Our specific suggestions for a well-designed performance testing framework for Trustee-directed products are set out from Page 30 of this submission.

We suggest an implementation period of 12 months once the approach for performance testing for Trustee-Directed products has been finalised.

13. Consult on improvements to the consequence management framework that maintains a clear set of consequences for trustees and enables APRA to focus its powers where there is sustained underperformance of trustee-directed products.

14. Undertake consultation on the best way for superannuation trustees to provide regular, meaningful performance information to members.

15. Ensure the ATO YourSuper comparison tool provides appropriate information to support effective consumer decision-making, including ensuring information is personalised wherever possible and a clear warning for consumers to consider other important areas such as insurance coverage.

16. Limit the scope of the ATO YourSuper comparison tool to MySuper products.

17. Maintain the Best Financial Interest Duty and provide further guidance around the scope of application for the Best Financial Interest Duty in the following areas:
    - expenditure that the trustee or service providers take from their own assets are not covered by the duty; and
    - the deduction of ongoing advice fees from a member's superannuation account.

3. Current performance test for MySuper products

3.1. General comments

The FSC supports an objective benchmarking performance test for MySuper products with clear consequences. The test intends to hold trustees to account for the investment performance they deliver and the fees they charge to members. As recognised by the Cooper review and the Productivity Commission's review into superannuation, a framework with a high bar for consumer protections is particularly important in a MySuper context where members' monies are defaulted by design into these products.

3.2. Test methodology

Measurement of actual return

Consultation question	
1.	Does the measurement of actual return using strategic asset allocation affect risk-taking behaviour by superannuation trustees?

Passing the performance test is now an explicit investment objective of trustees

In the context of the accumulation phase, risk-taking investment behaviour of superannuation trustees is driven by what trustees expect to deliver the highest risk-adjusted investment returns for their members over the long-term. As part of the implementation of the performance test, superannuation funds have reviewed and revised their MySuper investment strategy with much greater consideration given to monitoring and reviewing investments and investment strategies against the performance test benchmarks.

For many superannuation trustees, the risk of failing the performance test has been integrated explicitly into their investment governance framework as part of a fund's risk budget or risk allocation when setting, reviewing and revising a product's investment strategy. Trustees understandably want to manage the risk that their investment strategy tracks unfavourably to the current benchmarks and so now must weigh decisions by the likelihood of increasing a product's buffer over the performance test benchmark.

Short-termism stems from the rolling nature of the test

The performance test measures actual returns over a rolling eight-year period. Given the test measures historic investment performance, our members have observed that maximising the likelihood of passing the test in proceeding years requires a sharpened focus on the short-term investment horizon. This has led to tensions with a fiduciary approach to managing savings and retirement products with a long-term forward-looking objective. At times, this means risk-taking investment behaviour to ensure a product passes the test can be at odds with longer-term risk return trade-offs.

The rolling nature of successive performance tests means it is the difference in investment performance outcomes between the most recent year and the ninth year that falls off the latest performance test that matters for trustees in terms of minimising the risk of failing the performance test. Superannuation trustees therefore have an acute focus on the next one or two years of investment performance.

This is particularly problematic for years where a product's buffer above its performance test benchmarks is small. For example, a product may pass the performance test comfortably for a given eight-year period. However, if that pass was heavily attributable to very strong performance in the first year of that eight-year period, then given that good performance drops off for the next test, the product will need to replace that year of strong performance to maintain the same position. In this situation, it is more difficult for funds' risk budgets to accommodate investment decisions where there is expected to be greater volatility in returns over the short-term but stronger investment performance over the longer term. Examples of investments which typically exhibit this investment profile include private equity and hedge funds.

Changes to the performance test period must be justified

While lengthening the performance test period to say 10 years might help alleviate concerns that the test does not capture a sufficiently long enough time horizon, it would reduce the recency of the test and increase the lag between performance test outcomes and investment return outcomes. Lengthening the performance test period would also do nothing to solve for the main contributor pressuring the shorter-term investment time horizons for trustees: the test's rolling nature.

As the test is currently in place, there are also equity considerations for MySuper products that have already failed under the original test but would not have failed under a longer measurement timeframe. Consistent performance test treatment of MySuper products over time serves to maintain the integrity of an objective benchmarking test.

For these reasons, technical improvements to the test's measurement of actual performance should focus on minimising the artificial tracking error of a product's investment portfolio to their assigned benchmark. We define artificial tracking error as any tracking error that penalises valid investments and investment strategies when measured against a benchmark that does not reflect its risk-return profile. Minimising artificial tracking error would be better and more equitably achieved through efforts to refine the benchmarks currently in place and we detail our views below.

Recommendation

1. Maintain the current performance test approach to the calculation of actual return. Any increases to the lookback period of eight (8- years) to say ten (10-) years should only be done by incorporating new investment performance experience over time.

Current benchmarks

Consultation question

2. Does the current set of indices used to calculate benchmark returns unintentionally distort investment decisions or reduce choice for members? If so, is there a way to adjust the benchmark indices while maintaining a clear and objective performance test?

<u>The current indices reduce choice for MySuper members</u>

The test aims to measure a product's investment performance by reference to a benchmark constructed from the product's strategic asset allocation.

As outlined earlier, many superannuation funds have reviewed their asset class portfolio composition to test and better understand tracking error against each prescribed benchmark of the performance test. This has seen some shifts in weights and manager allocations away from investments and investment strategies that are not closely aligned to their assigned benchmarks.

While this approach may optimise for performance test outcomes, this has resulted in greater homogeneity in the investments and investment strategies adopted by and across superannuation funds. We observe this outcome is not strictly inconsistent with the characteristics of MySuper products which are required by law to be simple default product with a single diversified investment strategy.[1]

<u>The current indices distort investment decisions for MySuper products</u>

In general terms, investments and investment strategies that more closely track the product's strategic asset allocation and track their assigned index are encouraged because they deliver greater certainty for positive performance test outcomes over time thereby allowing greater risk budget for superannuation funds to expend on optimising for investment performance. In contrast, investments and investment strategies that do not match the risk-return profile of their assigned benchmarks are discouraged because of the additional tracking error risk they introduce to portfolios.

We therefore hold concerns that the current benchmarks continue to penalise otherwise valid investments and investment strategies that sit closer towards the efficient frontier, enable improved diversification and/or lower total portfolio risk. This may be contrary to members' best interests over the longer term.

Specific examples of discouraged investments and investment strategies include active strategies[2], emerging market assets, defensive low-volatility strategies within asset classes,

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[1] This includes lifecycle investment strategies.
[2] See Investment Innovation Institute (August 2022), Active Risk Levels Slashed [Website], accessed 16 September 2022 and Pension&Investments (July 2022) Australia super fund performance test a

inflation-linked bonds, floating rate debt strategies, tail risk hedging strategies, defensive alternative asset strategies.

<u>The benchmark indices should be expanded to reflect more granular asset data reported to APRA</u>

The underlying strategic asset allocation data used by APRA to run the performance test is currently sourced from SRF 533.0. Since the introduction of the performance test, APRA has released a new, more detailed asset allocation form SRF 550.0, which will enable fund performance to be assessed using a more refined and granular benchmark. We understand however that consistent reporting of data SRF 550.0 is a challenge, given the level of granularity of data required, and that the data is yet to be published by APRA (but will be from Q4 2022[3]).

Notwithstanding, we believe there is significant scope to refine some existing indices and add additional indices to improve the granularity of the measurement approach for MySuper products without compromising on the desire to maintain the test's integrity.

As we outline in Section 4, this is not the full answer for Choice products as relevant indices do not exist for all Choice investment options.

Recommendation

2. Include additional indices to account for the most significant variations in risk-return profiles of investments within the equity, fixed interest and 'other' asset classes.
3. Improve the Australian Unlisted Infrastructure Index to ensure it meets a commonly accepted market benchmark and reflects a natural investable universe.
4. Consider transitioning to international indices for international asset classes that currently utilise Australian indices (International Unlisted Property and International Unlisted Infrastructure).

We make our recommendations with the understanding that adding further indices must be balanced against the desire for a sufficiently clear and objective test to operationally administer from a data reporting and test determination perspective, particularly for MySuper.

Asset class	Current Index	Recommendations
Australian Equity	ASA52 S&P/ASX 300 Total Return Index	We **recommend** Government consider including additional benchmarks to distinguish for Large/Mid/Small/Micro-cap strategies as well as

headwind for active equity managers | Pensions & Investments (pionline.com) [Article], accessed 11 September 2022 for example.
[3] Based on APRA Response Paper SDT Publications and Confidentiality (July 2022).

Asset class	Current Index	Recommendations
		for Active/Passive strategies as superannuation funds now report this level of data to APRA on a best endeavours basis which is due to end for reporting periods ending on or after 30 June 2023 (SRS 550.0 Table 2 Columns 8 and 9). We note that data explicitly distinguishing for low-volatility or high dividend type strategies, which are often employed for members transitioning to retirement, is not currently collected by APRA. We suggest this be considered in the future in line with availability of this data.
International Equity (unhedged)	DN714533 MSCI All Country World Ex-Australia Equities Index with Special Tax (unhedged in AUD)	We **recommend** including two additional benchmarks to allow for strategies that distinguishes for developed and emerging markets. Superannuation funds now report this level of data to APRA (SRS 550.0 Table 2 Column 5). We **suggest**: • MSCI Emerging Markets Index (unhedged in AUD) • MSCI Developed Markets (ex Aust) Index (unhedged in AUD) This approach should be mirrored for International Equity (hedged).
Australian Unlisted Property	MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index - NAV-Weighted Post-Fee Total Return (All Funds)	We note the underlying funds in this index are not open to retail / platform investors and so caution against considering this index outside of a MySuper context.
International Unlisted Property	MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index - NAV-Weighted Post-Fee Total Return (All Funds)	We **recommend** further consideration as to whether an international benchmark should be utilised instead. We **suggest** the National Council of Real Estate Investment Fiduciaries (NCREIF) Fund Index – Open End Diversified Core Equity, although we note it is US focussed.

<table>
<tr><th>Asset class</th><th>Current Index</th><th>Recommendations</th></tr>
<tr><td>Australian Unlisted Infrastructure</td><td>MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) - Nav-Weighted Post-Fee Total Return (All Funds)</td><td>We recommend the regulator works with MSCI to improve this index to address the following concerns:
The index incorporates a value-add type return as they include a significant weighting to more cyclical, high return/risk assets. This has discouraged superannuation funds from holding ‘core’ infrastructure investments which are traditionally seen as the bedrock of infrastructure portfolios for their steady stream returns. Examples include regulated utilities and public private partnerships.
The index lacks transparency and does not provide the basic disclosure required as a commonly acceptable market benchmark. Given Australian superannuation funds’ meaningful exposure to the sector, an acceptable unlisted infrastructure benchmark should have a similar level of disclosure as the MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index.
Assets managed by IFM dominate the index, which creates a bias to IFM’s preferred investible universe versus a natural investable universe. The IFM bias distorts the return profile of the index - IFM is a large and active investor, and it could reset the market pricing of a particular type of asset via a large acquisition at a meaningful premium. Hence, an index dominated by IFM’s preferred investible universe would arguably have a biased return profile that benefits superannuation funds that invest with IFM and creates a disadvantage for other investors who do not (or cannot) invest with IFM.</td></tr>
<tr><td>International Unlisted Infrastructure</td><td>MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) - Nav-Weighted Post-Fee Total Return (All Funds)</td><td>We recommend further consideration as to whether an international benchmark should be utilised instead.

As noted above, this index includes significant weighting to more cyclical, high return/risk assets. It has a much larger exposure to transport assets (including airports) and Australia than one would expect for a global, diversified infrastructure portfolio. This has discouraged superannuation funds from holding ‘core’ infrastructure investments which are traditionally seen as the</td></tr>
</table>

Asset class	Current Index	Recommendations
		bedrock of infrastructure portfolios for their steady stream returns. We **suggest** the use of MSCI Global Quarterly Private Infrastructure Asset Index as a more appropriate index. The underlying exposures captured by this index are private infrastructure investments that are held in professionally managed portfolios globally by (typically) insurance and pension funds, sovereign wealth funds, unlisted pooled funds, and listed infrastructure companies. Some adjustments may be necessary to cater for example to: • Exposures by region: Europe/UK (44%), Australia (32%), North America (23%) as of March 2022; and • Exposures by risk style: moderate risk (66%) and low risk (34%) as of March 2022.
Australian Fixed Interest	BACM0 Bloomberg Ausbond Composite 0+ Yr Index	We **recommend** including one additional benchmark to distinguish between short-term and long-term Australian fixed interest investments. We **suggest** the ‘Bloomberg Ausbond Composite 0-3 years Index’. There are significant variations in risk-return profiles within the fixed interest asset class. The current index is suitable for measuring relatively long duration exposures, but not a good measure for shorter duration and floating rate credit strategies that offer protections for members against duration risk of changing interest rates. Superannuation funds now report this level of data to APRA on a best endeavours basis which is due to end for reporting periods ending on or after 30 June 2023 (SRS 550.0 Table 2 Column 9). We **recommend** further work be undertaken to incorporate inflation linked bonds and high yield credit strategies within the fixed interest asset classes. This level of data is not currently collected by APRA. We suggest this be considered in the future in line with availability of this data. We **suggest** the ‘Bloomberg Ausbond

Asset class	Current Index	Recommendations
		Inflation 10+Yr Index' or failing that the 'Bloomberg Ausbond Inflation 0+Yr Index' for benchmarking exposures to inflation linked bonds.
International Fixed Interest	LEGATRAH Bloomberg Barclays Global Aggregate Index (hedged to AUD)	We **recommend** including one additional benchmark to distinguish between short-term and long-term international fixed interest investments. We suggest the 'Bloomberg Barclays Global Aggregate (1-3 years) Index (hedged to AUD)'. Superannuation funds now report this level of data to APRA on a best endeavours basis which is due to end for reporting periods ending on or after 30 June 2023 (SRS 550.0 Table 2 Column 9).
Other (including Commodities)	25% International Equity (hedged) 25% International Equity (unhedged) 50% International fixed interest	We **recommend** including two additional categories within the 'Other' asset class so that it distinguishes between Alternative, Alternative Defensive and Alternative Growth. Superannuation funds now report this level of data to APRA (SRS 550.0 Table 2 Column 2). There are significant variations in risk-return profiles within this asset class which spans from conservative credit investments through to venture capital and private equity investments. We are not supportive of the current benchmarking approach of using listed market indices to these investments as it artificially creates a significant levels of tracking risk. The current single benchmark approach for 'other' has also had two perverse impacts: • First, it provides a lower benchmark for high return/risk investments. This is because they are assessed against a benchmark that consists of 50 per cent international fixed interest. • Second, it provides a higher benchmark for low return/risk investments, for example conservative credit investments. This is because they are assessed against a benchmark that consists of 50 per cent international equities.

Asset class	Current Index	Recommendations
		In the experience of FSC members, many superannuation funds have recalibrated their alternative asset allocation to 50/50 global equities/bonds to reduce tracking error. To do this, exposures to defensive alternative assets have been significantly reduced or removed entirely. Defensive alternatives assets have historically been used for diversification of a portfolio and protecting on the downside. However, these strategies were never engineered to outperform the performance test listed benchmark of 50/50 global equities/bonds, but offer important diversification benefits to the cyclical, higher risk/return benchmark. These changes coincided with the worst joint performance of equities and bonds in nearly a century. **An absolute return target would be most appropriate here as this asset class is designed to protect the value of the portfolio with low correlation to traditional equity and bond markets.** Our second preference would be to adopt indices for each of these alternative categories, such as: • Alternative – HFRI Fund of Fund Composite Index* or HFRI Asset Weighted Composite Index* • Alternative Defensive – Barclays Global Fixed Income Index, HFRI Fund of Fund Conservative Index* or HFRX Absolute Return Index*. • Alternative Growth – HFRX Global Index*, FRI Asset Weighted Composite Index* or HFRI Equity Hedge (Total) Index – Asset Weighted*. * the HFRI indices are quoted in USD and may need to be converted to AUD with hedged and unhedged versions to allow for the way funds may submit the APRA data forms. We recognise there would be an inconsistency in the asset mix of these suggested benchmarks for the ‘other’ asset classes, but still consider them an improvement on the current approach.

Asset class	Current Index	Recommendations
		Failing these suggestions, a relatively crude improvement would be to revise current weightings for each category as follows: • Alternative – as is (for managers that report Alternatives as one category). • Alternative Defensive –25% International Equity (50/50 hedged and unhedged), 75% International Fixed interest because this would result in a more appropriate lower equity beta than the current mix. • Alternative Growth - 50% International Equity (50/50 hedged and unhedged), 50% International Fixed interest. This would be more appropriate than a 75/25 weighting given the low correlation to traditional equity and bond markets. Note we define alternative defensive as investments designed to protect the value of the portfolio with low correlation to listed equities.

Calculation of actual and benchmark RAFE

Consultation question

3. Does the calculation of actual RAFE and benchmark RAFE discourage non-performance related product features that members may value (such as customer service or platform products)? If so, can this be addressed without diminishing the test's focus on performance?

The current approach to measuring actual RAFE and benchmark RAFE is focused on performance from a cost minimisation perspective. While non-performance related product features that members may value are important, we consider the strict focus on cost-related performance appropriate for MySuper products which are required by law to be simple default product with a cost-effective focus.

The FSC maintains strong support on the existing approach for MySuper to calculating actual RAFE based on current administration fees at the time of the assessment, as this reflects the member's current experience and is a more accurate predictor of fees going forward.

As outlined in a previous FSC submission, using current administration fees reported on a like-for-like basis:

- Removes problems with accuracy and inconsistencies of historical fee data preventing clear comparability;

- makes it easier to incorporate fee discounts to provide a more accurate assessment of actual member experience;
- provides a more accurate assessment of current member outcomes, which are more relevant to a member considering their fund choices;
- creates an immediate incentive for funds to lower administration fees, particularly where products are at risk of failing the assessment; and
- maintains the integrity of the original investment performance assessment.

There is clear evidence that demonstrates the current approach has been successful in lowering MySuper product fees to the benefit of members:

- According to superannuation consultant KPMG, the average RAFE reduced from 0.36% to 0.32% over the 12 months leading up to the first MySuper performance test.[4]
- According to asset consultant JANA, the median RAFE has fallen further from 0.33% to around 0.27% over the recent 12 months corresponding to the second MySuper performance test.[5]

There should be a more holistic focus when approaching the RAFE construction for non-MySuper products (i.e. Choice products) where there is more scope for ancillary product related features that improve consumer experience. For certain choice products such as platforms where members' focus is on value from extra features and customisability of their investments, the current methodology would not assess broad choice products on a like-with-like basis where the results would fail to consider the non-financial performance aspects of product offerings. For example, if the identical RAFE methodology applies to an assessment of a platform against generic unitised choice products, the result would be more favourable for the non-platform products, which would discourage trustees from offering these features to their members. This would ultimately be detrimental to the members of these products who have made their own choice to seek such features.

Recommendation

5. Maintain the current approach to the calculation of actual RAFE and benchmark RAFE for MySuper products.

Longer term impacts

Consultation question

4. What are the longer-term impacts of the performance test on market dynamics and composition? How will these factors impact on long-term member outcomes.

[4] KPMG (May 2022), Super Insights 2022, accessed 16 September 2022.
[5] JANA (September 2022), Performance Test – more questions as well as answers [Website], accessed 16 September 2022.

Although it is still early to conclude on longer term outcomes, we offer some observations as to how impacts have already played out in the MySuper space and discuss long term implications.

As outlined earlier, passing the performance test is now an implied investment objective for superannuation funds. Given the significant consequences of failing the test on the sustainability and solvency of the fund, many superannuation trustees have taken the view that passing the performance test is a minimum standard to continue to participate in the industry. This outcome is in line with the policy intent and consistent with the Productivity Commission's review.

Many have observed that market consolidation has accelerated in situations where funds have had their MySuper product fail the performance test. As noted in the Consultation Paper, ten of the thirteen MySuper products that failed the first performance test have merged or are in the process of being merged into another fund. More consolidation however introduces more concentration and the associated concentration risk and reduction in competition.

Over time, we expect that as the performance test becomes better understood and therefore better managed by superannuation trustees, there will be fewer products that fail the performance test. This is clearly a positive outcome for members in terms of ensuring that default superannuation products meet a clearly defined and acceptable level of performance.

We also note research published by CEM Benchmarking which back tested the YFYS test retrospectively from 1992 to 2022 across different pension funds globally and found that the YFYS test, over the long term, is likely to contribute to improvement in system-wide performance.[6]

However, the severe consequences of failing the performance test means it will remain as the most critical objective from a solvency perspective for many superannuation trustees. This will prevent superannuation trustees in moving their focus away from the performance test. A diminished focus on the performance test might be desirable as it would mean superannuation trustees could spend more time on other areas such as implementing and enhancing their member outcomes, retirement incomes and insurance in superannuation frameworks.

It should not be lost that the performance test assesses how well a fund has implemented its investment strategy against its strategic asset allocation. This component is less important to member outcomes than the appropriateness of the investment strategy itself which is part of a superannuation trustee's investment governance framework. As an extreme example, a passive cash option would always pass the YFYS test but would not meet the needs of a typical default accumulation member. Conversely, a well-designed passive option that was low cost likely would pass the YFYS test.

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[6] CEM Benchmarking (June 2022), What is the value of the Your Future, Your Super test?.

As such, it is unclear how far trustees will be able to move or if they will ever be comfortable to try innovative investment strategies that are potentially value add but off benchmark. It seems inevitable that there will be some reduction in investment innovation as a result, for example to investments to support the climate transition or affordable housing.

<u>ESG investing</u>

There has been some discussion of the impact of the performance test on pursuing investments with regard to environmental, social and governance (ESG) risks and opportunities. The FSC and our members consider that ESG factors is an important aspect to integrate into long-term investing. There is clear evidence that shows integrating ESG considerations into investment decisions has led to stronger long-term financial performance over multi-sector asset classes and most investment horizons.[7] Hence over the longer term, we do not expect significant distortions in ESG-integrated strategies for MySuper products. However, the performance test might limit more heavily weighted ESG strategies that go towards more socially responsible or impact based investments and investment strategies (seen in the Choice space but do not currently exist for MySuper products).

3.3. Consequences of failure

Consultation question

5. Is there evidence to indicate that the notification and website publication requirements have been effective at encouraging members to consider, and switch to, alternative products? Are there ways this could be improved?

We consider the existing disclosure requirements to members have had mixed effectiveness at prompting member engagement. We believe there is more scope to making the prescribed and website publication requirements more meaningful to better empower members to make the right decision rather than prompting members to make any decision.

Towards this objective, we recommend that the prescribed information notice that trustees must provide to members in a MySuper product that fails the annual performance test be amended to include:

- A statement about the consequences of changing products and for them to consider their current circumstances, including the potential loss of insurance benefits and a recommendation to contact the fund to check whether there will be any costs involved;
- A statement that the performance assessment does not necessarily reflect the member's actual outcomes, including the ability to note any fee discounts that apply or actual lifecycle cohort performance where appropriate; and
- A reference to the fact that a non-MySuper product may be appropriate for some members.

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[7] According to the Responsible Investment Association Australasia, multi-sector responsible investment products continue to outperform the overall market over all timeframes. See Responsible Investment Benchmark Report 2022 Australia.

Recommendation

6. Revise content of member communications to ensure that appropriate considerations for members changing products or funds are clearly listed, including potential impacts on insurance coverage.

Consultation question

6. Have the consequences been effective at encouraging trustees to improve their performance or merge with better performing products? Are there ways this could be improved?

We consider the existing consequence management framework in place sufficiently severe for addressing persistent underperformance in MySuper products.

FSC and its members do not object to taking a hard line approach for the consequences of failing the annual performance test for MySuper products. Where trustees fail to meet a defined standard of investment performance for their members for two consecutive years, the consequences for underperformance should rightly ensure that new members can no longer be accepted into the product until a subsequent test is passed.

Except for the evidence of the reduced fees on MySuper products, we do not yet believe it is clear whether the performance test has meant trustees have delivered better performance for their members either by improving their actual investment performance or merging with better performing products than they would have otherwise.

Recommendation

7. Maintain the consequence management framework for MySuper products.

Consultation question

7. Are the measures in place to resolve underperformance sufficient given the potential for members to be stapled to these products? How can the system best support members in underperforming products?

This issue goes towards ensuring disengaged members in products that are subsequently identified as underperforming receive appropriate protections. For members that are disengaged and in a persistently underperforming product, the responsibility falls on their superannuation trustee to take action to transfer members out of that product. As noted earlier in Section 3.2, many underperforming products have been or are in the process of being transferred via successor fund transfer (SFTs) to another fund.

According to APRA, there are a total of 568 choice products covering approximately 9,000 distinct investment options. Of these choice products, 208 (or 37 per cent) are closed to new members and are considered legacy products. APRA identified structural issues in the Choice sector included the proliferation of products, investment options and legacy products.[8] FSC members observe the lack of Capital Gains Tax (CGT) rollover relief for transfers of individual products within the same or a different fund as a decisive barrier preventing superannuation product rationalisation in the Choice sector.

Importantly, permanent CGT rollover relief now applies to SFTs of the entire superannuation fund. While we welcome this measure and believe it has worked well for some members, further reform is needed to adequately support simplification and rationalisation of superannuation products.

The FSC strongly supports extending CGT rollover relief to cover the rationalisation of investment structures and individual superannuation products. Introducing this tax relief will assist in consolidating the number of investment vehicles and individual products in superannuation funds, and will dramatically assist funds in dealing with any underperformance in individual products.

Superannuation trustees unable to improve performance of a particular product identified as underperforming based on the Your Future Your Super performance test will need to consider options for moving members to better performing products. While tax relief is available if an entire fund is merged with another fund, there is currently no such relief where performance could be improved by transferring members and underlying assets to another product within the same fund. In the absence of relief, members will incur tax (which may be substantial) on any capital gains arising from the sale or transfer of the underlying assets.

There is also no rollover relief to simplify and rationalise underlying investment structures where a product or an entire fund is merged with another fund. Without this relief, any merger/transfer of a superannuation fund or product will mean the cost and inefficiency issues could easily perpetuate in the successor fund, limiting further potential improvements in performance. Introducing these rationalisation schemes will provide additional avenues for the underperformance of individual products to be addressed, including by simplifying and rationalising the investment structure of the existing fund, rather than needing to transfer that structural complexity and attendant costs to the successor fund.

We specifically recommend that:

- Rollover relief would be available for assets supporting a superannuation product where the member interests in that product are identifiable.
- Any transfer would need to be in the best financial interests of members – similar to the current rule required for a super fund merger (successor fund transfer).
- The transfer of assets relating to the product would not be a taxing point. The original cost base of the assets would be retained.
- The fund members would not have any tax or social security impact from the transfer of the assets of the product.
- Rollover relief would be available for the consolidation of Managed Investment Schemes where there is no change in ultimate beneficial entitlement to distributions of income and capital.

[8] APRA Information Paper on Choice sector performance (October 2021).

We note that tax relief was provided when fund members were moved from ‘old’ default superannuation products to MySuper products – the relief we are proposing would mirror this relief, also covering underlying investment structures. The case for this proposal is similar to the case for the relief provided for MySuper. These changes can be most easily and quickly implemented by copying the expired sections 311-12 and 311-42 into Division 310 (with only the smallest of drafting changes).

We also note a long-standing review of the Australian Government’s Board of Taxation on CGT Roll-overs.[9] We would suggest the outcomes of that review be expedited.

Recommendation

8. Facilitate product modernisation in superannuation triggered by the Your Future, Your Super reforms, by extending the capital gains tax rollover relief for mergers of superannuation funds to additionally include the transfer of superannuation products within a fund.

[9] https://taxboard.gov.au/consultation/review-of-cgt-roll-overs

4. Performance testing beyond MySuper products

4.1. The nature of Choice products

The FSC has long advocated for reforms that will improve the efficiency of the whole superannuation system and improve outcomes for all members, and we reiterate our support for the overall intent of performance testing as a means of holding trustees to account for the investment performance they deliver and the fees they charge to members.

Critically however, appropriate performance testing, in driving additional accountability on the investment performance of superannuation trustees, should not undermine the overarching notion of superannuation member directed choice and genuine product innovation. For example in the case of Externally Directed Products (EDPs), it would be inappropriate to apply a performance test to investment options for which a superannuation trustee does not control the investment strategy's implementation.

We draw attention to the precedent set by Government to recognise that the standard benchmarking approach is not appropriate for faith-based products. Like faith-based products, a superannuation member's decision to invest in one or more choice products may derive from their personal beliefs, goals and values. The retrospectively applied objective measured in the performance test will not align with client directed beliefs, goals and values in a number of circumstances. Specific examples for multi-sector Choice accumulation products, beyond faith-based products include goal-based products and Environmental, Social and Governance (ESG) products.

The precedent that has been set for faith-based products to give APRA greater discretion when administering the performance test is not distinguishable in practice to many other forms of superannuation products. The issue is not whether the investment goals or objectives impact investment performance as measured against the performance test, but rather whether products are being assessed against metrics which reflect the objectives and strategy they are designed, disclosed and implemented for the members that chose to be in that product.

Distinguishing characteristics

There are fundamental differences between MySuper products and non-MySuper products that are not defined benefit products ('Choice products'). We first highlight the distinctions at law between these products:

- MySuper products are a deliberate policy construct arising from the Cooper Review.
- MySuper products have their own specific provisions in the *Superannuation Industry Supervision Act* 1993 (SIS Act) in Part 2C which commenced from 1 January 2014 (Choice products do not).
- MySuper products are the only products permitted to accept superannuation contributions by default.

    - Since 1 January 2014, only funds offering a MySuper product have been eligible to receive default superannuation contributions relating to new employees.
    - Since 1 July 2017, all member accounts in default investment options are required to be invested in MySuper products.
- MySuper products are deliberately supported by legislation which sets out specific requirements for common product characteristics including:
    - A single diversified investment strategy (lifecycle based on age is permitted). Members are prevented from making investment decisions related to their MySuper product – a member who wishes to make an investment decision must move to a Choice product.
    - All members are entitled to the same benefits, options, and facilities except for risk insurance
    - Fees may only be charged for particular reasons as set out section 29V(1) – charging rules in section 29VA
- MySuper product requirements are also subject to additional oversight by APRA as an RSE Licensee must first be granted authority from APRA before it can offer a MySuper product.
- These common requirements for MySuper products make it reasonable to design and apply a singular test for net investment performance of MySuper products. These common requirements do not exist for Choice products.

In its Inquiry Report *Superannuation: Assessing Efficiency and Competitiveness*, the Productivity Commission (PC) recognised that choice products are inherently different to default (MySuper) products:

> *In many ways, it [the Choice segment] is inherently different from the default segment. On the demand side, members are more likely to have exercised some level of choice about the product or option they are invested in. On the supply side, the products on offer are more heterogeneous, and some provide flexibility to adjust the mix of assets in the portfolio, such as through the use of platforms. As such, trustees may have less direct control over the asset mix ultimately selected by choice members.*[10]

Role of the financial adviser

Members investing in Choice products have actively decided how to invest their superannuation savings, in consideration of their individual needs and objectives. As such, these members are not a homogenous cohort. Many members who choose Choice products have a financial adviser to assist them in managing their superannuation.

For example, a superannuation member that holds a portfolio of investment options on the recommendation of a bespoke investment strategy from their financial adviser. Applying a performance test to investment options within their Choice superannuation product intrudes on the role and duties the financial adviser has in reviewing and monitoring their portfolio at

[10] PC Inquiry Report Superannuation: Assessing Efficiency and Competitiveness, page 124.

a holistic level. It is critical that performance testing outcomes do not subordinate the role of the financial adviser who is best placed to consider the financial objectives and circumstances of their client.

To inform Government's understanding of the extent to which members invested in a Choice product receive financial advice, FSC has obtained data from financial services consultant firm NMG Group. The data has been disaggregated by segment, given the difference in proportions of members that are advised across each segment. The data clearly shows that members entering a Choice product through a platform or retail master trust overwhelmingly receive financial advice when selecting a Choice product.

Segment	Industry and Public	Corporate Master Trust	Retail Master Trust	Platform/Wrap
Advised proportion	Very small amount advised (est 1%)	None advised (on entry, as default by employer)	99% entered based on advice	99.9% entered based on advice
Investment Use	Predominantly multi-sector investment options	Mostly multi-sector investment options (some single sector investment options that are member led)	Circa two-thirds are multi-sector investment options (although many members also have one or more additional single sector options)	Predominantly single sector options (less than <10% multi-manager and multi-sector investment options)
Number of Members	3.7m	0.5m	2.15m	1.2m
		3.8m members total across Retail		
Advised Members	30K	Nil	2.1m	1.2m
		3.3m advised members across Retail		

Data as at 30 June 2021, and reflects data sourced from medium and large superannuation funds covering 97 per cent of the APRA-regulated market (which excludes SMSFs).

4.2. Existing frameworks

Performance testing (if implemented) for Choice products should stand on top of the existing legal and regulatory frameworks designed to hold trustees to account for the investment performance they deliver and the fees they charge to members.

Trustees are already expected through these regulatory frameworks to continually assess, review and improve how they are delivering outcomes for members via the legislative requirements of the outcomes assessment, the business performance review, APRA heatmaps, investment governance and the Design and Distribution Obligations (DDO).

Role of the member outcomes governance framework

Trustees are held to account on delivering strong member outcomes under the SIS Act and *APRA Prudential Standard SPS 515 Strategic Planning and Member Outcomes* (SPS 515). The objective of SPS 515 is to ensure that an RSE licensee manages its business operations in a sound and prudent manner to achieve its strategic objectives, including rigorously assessing its performance and taking action to improve its operations consistent with its obligations under the SIS Act. This includes annually assessing and comparing the quality and competitiveness of the RSE licensee's superannuation products in accordance with section 52(9) of the SIS Act.

APRA has recently issued a discussion paper for consultation on its proposals to strengthen requirements for SPS 515 and to ensure that the superannuation prudential framework is anchored by the revised SPS 515. As part of this process, APRA has signalled it will use the SPS 515 framework to deal with underperforming products, even where the product has not failed the performance test.

Role of the APRA heatmaps

APRA publishes heatmaps to increase the transparency and scrutiny of performance delivered by superannuation product offerings. The first Choice heatmap was published in December 2021. It covered 120 products consisting of 727 multi-sector investment options covering a significant proportion of member benefits in the choice sector (estimated to be $394 billion or 40 per cent of the choice sector). Broadly, the options covered in APRA's first Choice heatmap are similar in nature to Trustee-Directed Products but excludes investment options offered through platform-style superannuation products.

In its first Choice heatmap, APRA's approach to measuring investment returns, fees and costs of multi-sector investment options was to adopt a multi-metric approach. We note heatmap performance was derived by taking the average of the investment return relative to four heatmap benchmarks.

APRA has sourced data for the initial Heatmap from SuperRatings, including investment returns and fees for choice investment options. APRA plans to expand the coverage of the Choice Heatmap in future years, using data reported to APRA under the superannuation data collection.

APRA's heatmap is used to identify those choice products that are failing members by charging high fees and/or delivering poor investment returns, and is an important tool for trustees when undertaking their annual outcomes assessments and business performance review.

Role of the investment governance framework

Trustees are held to account on strong investment governance requirements under *APRA Prudential Standard SPS 530 Investment Governance* (SPS 530), with strengthened requirements to commence from 1 January 2023. SPS 530 includes requirements for trustees to:

- formulate specific and measurable investment objectives for each investment option, including return and risk objectives;
- develop, maintain and implement an effective due diligence process for the selection of investments;
- determine appropriate measures to monitor and assess the performance of investments on an ongoing basis; and
- review the investment objectives and investment strategies on a periodic basis.

Role of the Design and Distribution Obligations framework

The DDO regime is designed to assist consumers to obtain appropriate financial products by requiring issuers and distributors to have a customer-centric approach to designing, marketing and distributing financial products. It includes requirements for product issuers to have a product design and product distribution governance framework.

Under the DDO regime, a superannuation trustee would need to examine investment options inside a Choice super product and determine if the options can meet the objectives, financial situation and needs of members. The trustee would be expected to stop providing options that do not meet this test. A trustee that failed to take these steps would face the risk of a DDO stop-order on the distribution and issue of that product to consumers, or the use of ASIC's product intervention powers (PIP) on the product.

These various regulations and requirements under the DDO and PIP regimes mean there is a reduced need for expanded YFYS testing of Choice products.

We also note the DDO regime does not apply to MySuper products. According to the Explanatory Memorandum to the Bill implementing the DDO legislation, MySuper products 'are currently subject to product-specific regulations that are also aimed at ensuring that firms provide appropriate products to consumers'.[11]

4.3. Performance testing trustee-directed products

Consultation question	
8.	Are there significant issues to be expected when the test is extended to TDPs? If so, how could these issued be addressed?

There are critical issues that arise from both the scope and application of the current performance test if extended to TDPs as it is currently defined under the regulations.[12]

Definition of a trustee-directed product

The Consultation Paper defines TDPs as multi-sector Choice accumulation products where the trustee or a connected entity controls the design or implementation of the investment strategy. We consider that extending the performance test to multi-sector Choice

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[11] Paragraph 1.20 of the Explanatory Memorandum
[12] *SIS Regulations 1994* - REG 9AB.2

accumulation products has some merit as these types of choice products are considered to be similar to MySuper products (but with greater diversity). However, we outline below our concerns that the current definition does not work as intended (and suggest solutions).

Exclusion for Single Sector products

The current exclusion includes options with two asset classes, where the option's SAA does not require it to hold greater than 10 per cent of assets in each asset class. We observe instances where a product will have three asset classes but otherwise is still effectively considered a single-sector product by investors and industry participants.

- An example of such a product, the Nikko AM Australian Share product which is primarily invested in domestic equities but has less than 10 per cent of assets in listed property and cash.
- Another example is the AMP Capital Wholesale Australian Property Fund, which is primarily invested in direct property (unlisted property), but also includes exposure to listed property and cash.

  In more general terms, the same issue appears for products with exposures to listed and unlisted infrastructure, and cash (another example is the AMP Capital Core Infrastructure Fund). These are commonly seen as single-sector products by investors and industry participants.

We detail why extending the performance test to single-sector products is inappropriate in Section 4.4.

Exclusion for retirement products

The current TDP definition excludes products that have any beneficial interest in the product that supports a superannuation income stream in the retirement phase.

While we broadly agree with the intent of this exclusion to exclude retirement products, it would seem that under the current drafting any investment option that holds even a nominal amount of pension funds would be excluded from the performance test.

We detail why extending the performance test to retirement products would be inappropriate in Section 4.4.

Inclusion of TDPs which are controlled by a "connected entity"

We also highlight that the current TDP definition captures investment options controlled by a "connected entity" of the Trustee, however in practice this potentially captures a large number of options that a trustee has, in fact, no control over.

In particular, the implementation of the "no other role or office" requirements (Recommendation 3.1 of the Financial Services Royal Commission) prohibit trustees of a registrable superannuation entity from assuming any obligations other than those arising from or in the course of its performance of the duties of a trustee of a superannuation fund. In practice, this means that trustees now operate entirely independently from any connected entities such as fund managers.

For example, a conglomerate business may have a superannuation wrap product which provides members the opportunity to invest in products designed by a fund manager that is a connected entity. The conglomerate's superannuation trustee will have no more control over the design and investment strategy of that product than the trustee of an entirely separate fund. The only decision the trustee makes is whether to offer the product to members on its investment menu. The member, usually with the help of a financial adviser, will then build an investment portfolio that is suited to the member's needs and objectives. As each member will have a customised portfolio, the investment returns, and fees payable will depend on the investments they have selected.

We recommend revising the TDP definition to ensure investment options that are directly selected by the member and managed independently of the trustee by another fund manager (including by a connected entity), are excluded from TDP performance assessments. These investment options should be treated in the same category as externally directed products (EDPs).

We detail why extending the performance test to EDPs would be inappropriate in Section 4.4.

Recommendation

9. Ensure the exclusion of single sector products and retirement products within the Trustee Directed Product definition operates as intended.
10. Clarify the application of the Trustee Directed Product definition to ensure investment options where the trustee has no control or influence over the investment strategy are excluded (including where the investment option is issued by a connected entity).

Application of the current test

As discussed earlier for MySuper products, the current performance test discourages investments and investment strategies that do not match the risk-return profile of their assigned benchmarks. This perverse impact would be compounded if the current test were to be applied for multi-sector Choice accumulation products given the much wider range of investment strategies and styles available even within this product segment.

> **Case Study**
>
> Analysis by product research firm SuperRatings highlights the anomalous outcomes from applying the current performance test to TDPs.[13]
>
> In the 8 years to 31 March 2022, SuperRatings estimated that approximately 20 per cent of the circa 650 TDP investment options would likely fail the test. However, in the 8 years to 30 June 2022, this reduced to 7 per cent. Such large deviations in outcomes based on 3 months of data raise questions around the appropriateness of the current test.
>
> The analysis also found that allocations to unlisted property, diversified fixed interest, Australian and international shares were the primary drivers of whether or not an option passed the test, and given the difference in outcomes over 3 months of data, it would suggest that the indices used for these asset classes are clearly not fit for purpose.

Goal-based products

Goals based products are offerings that tailor their investment strategy to achieve specific financial goals. These products are not designed by reference to a strategic asset allocation (SAA) but are run to alternative investment objectives such as:

- products designed specifically for income such as providing a set return above inflation for a particular class or classes of superannuation members like those transitioning to retirement;
- products designed to manage volatility; and
- products designed to provide capital protection.

Goals-based products are implemented in ways that are designed to maximise the likelihood of meeting objectives, which are based on both return and risk or probability of loss. These products do not require an SAA to dictate or proxy the level of risk they run at. In practice, these products are required for regulatory reporting purposes to set wide benchmark allocation ranges between prescribed asset classes.

For members that are transitioning to retirement, goal-based products are particularly important as they provide stable, risk-adjusted returns above inflation with lower volatility. To achieve this objective, the product is managed with a focus on income and franking credits and often has a lower beta market profile. Benchmarking against listed indices that perform

[13] See Lonsec August 2022 Article and Lonsec June 2022 Article.

differently, assume a higher level of risk and do not consider income distributions or post tax benefits will therefore not provide an accurate measure of performance.

ESG products

Members often seek out specifically designed ESG products to incorporate broader social, environmental and/or other ethical objectives other than or alongside pure investment performance. ESG products are increasingly prevalent in the Choice sector and vary widely in their composition and investment methodology.

Given this diversity, the existing benchmarks may be misaligned with intended outcomes of these products and are not a reliable source against which the member experience of the ESG options can be easily measured (at least over the shorter term) given the non-financial objectives of many of these options. As such, it may not be possible to adopt a similar performance testing approach for ESG products to that currently in place for MySuper, as utilising the existing benchmarks would not provide an accurate measure of performance.

Need for a multi-dimentional approach

Performance test measurement

While additional benchmarks to refine the current set of prescribed indices would certainly improve the test, in our view this can only go so far to solving for the issues with extending a single metric test to multi-sector Choice accumulation products. If the Government were to proceed with the current test, a relatively straightforward adjustment would be to apply a wider level of performance tolerance however this is clearly not ideal either.

Therefore, the FSC fundamentally questions the idea that simply adding more benchmarks to the performance test for TDPs would be a suitable approach.

Instead, performance testing should move away from the use of a single performance metric to a multi-metric approach while still maintaining the integrity of a clear and objective test as desired by Government.

This concurs with the conclusion of the Productivity Commission. While it recommended an elevated outcomes test should apply to Choice products, the recommendation was for this test to consider a range of metrics including but not limited to net investment performance. It also suggested there should be less focus on investment strategies in light of the additional control Choice members had over managing their investment strategy.

> *In applying this elevated outcomes test to choice products, funds would need to consider administration fees, member services, insurance and financial advice provided by the fund. There would presumably be a lesser focus on the appropriateness of investment strategies for choice members, given the potential for members themselves (or their advisers) to set their own investment strategy.*[14]

[14] PC Inquiry Report Superannuation: Assessing Efficiency and Competitiveness, page 491.

This multi-metric approach should consider:

- **The investment option's performance against its stated investment objective. This is the most important performance measure for Choice superannuation members.**
- Metrics for risk-adjusted returns and volatility (for example, Sharpe ratio). We note APRA has approached the issue of a single performance metric in its Choice heatmap by using four investment performance metrics.
- Multiple lookback periods (for example, 5, 7 and 10 years).
- Reconsideration and consultation of the appropriate representative member for TDPs. Our experience suggests that the representative member balance would be higher for members that hold TDPs. This reflects the fact that certain TDPs, particularly those offered on platforms require a minimum account balance. We note APRA approached this technical issue in their initial publication of the Choice heatmaps by publishing results using multiple member balances ranging from $10,000 to $250,000.

Any multi-metric approach would necessarily require some level of design judgement, for example in relation to determining appropriate weightings, when administering the performance test and to check that performance test outcomes for Choice investment options appropriately reflect members' objectives and experiences. This would naturally be a matter for further Government, and possibly also APRA, consultation.

<u>Implementation considerations</u>

We note and understand the Government's desire for performance testing to be extended to TDPs from 2023. However as indicated by the Consultation Paper, this is predicated on the assumption that there will not be material amendments to the current performance testing framework for TDPs impacting trustees' implementation timeframes.

Extending the current performance testing framework next year will have catastrophic consequences to the current and forward-looking diversity and innovation in the Choice product market and for the consumers (and their advisers) that desire these products.

Critically however, we believe performance testing can be done well but this will require a fit for purpose framework and a workable implementation timeframe to avoid significant undesirable consequences.

Superannuation funds and investment managers consider in detail the performance test benchmarks when building new strategies for both MySuper and Choice products. It is therefore critical that adequate notice is provided before any changes to the performance test or underlying indices take effect. If changes are made without sufficient advance notice for managers to adapt strategies, this will result in unintended strategy changes which could trigger large transaction costs, spreads and liquidity issues.

In our view, the extension of performance testing to TDPs 12 months from when the approach for performance testing has been finalised, that is from 2024, would offer clear benefits:

- It would allow APRA, superannuation funds and investment managers a natural sequence to consider and implement the changes necessary to ensure a robust performance testing framework for MySuper products and then for TDPs.
- It would allow performance testing of TDPs to be introduced with a consistent lookback period of ten (10-) years. If it were to be introduced next year, APRA would only have available nine (9-) years of investment return data. Consistent performance test treatment of TDP products over successive years maintains the integrity of an objective test.
- It would allow time for APRA to collect more granular data from superannuation funds to incorporate further indices to refine the current benchmarks. The areas of priority should include catering for low-volatility equity, high dividend equity, inflation linked bonds and high yield credit type strategies.

Recommendation

11. Make clear that there is no intent to extend the existing benchmark performance test approach to Trustee-Directed Products and other Choice products.
12. Undertake further consultation to determine the most appropriate approach and implementation timeframe for introducing performance testing for Trustee-Directed products.
    We suggest an implementation period of 12 months once the approach for performance testing for Trustee-Directed products has been finalised.

Consequences of failure for trustees

The FSC understands and accepts the merit for outlining a clear set of consequences for products that fail the performance test. However, these consequences must be reasonable and reflect circumstances where it is genuinely the performance of the trustee that has caused persistent underperformance.

For TDPs, we see merit in a greater role for trustees and APRA in how areas of genuine underperformance are understood and rectified. This is necessary to address the inherent risk of 'false positives' for investment options that fail the performance test but which are not genuinely underperforming and provide good member outcomes.

We take the opportunity to propose a clearly defined consequence management framework that would:

- require trustees to provide to APRA (and implement) an action plan to address the underperformance, including determining when underperforming options will be closed;
- require the action plan to include communications to advisers and previously advised clients regarding the closure of investment options; and
- place the burden on trustees to demonstrate to APRA that is taking clear actions to address underperformance and, if not, that these investment options are closed to new members.

Such a framework would continue to place a clear set of consequences on trustees whilst reducing the operational burden on APRA to initiate and conduct investigations for the large number of TDP investment options. It would also allow APRA to focus its efforts through close and continuous monitoring on those trustees and investment options for which there are clear deficiencies in investment performance and for which the trustee is not taking appropriate action.

Recommendation

13. Consult on improvements to the consequence management framework that maintains a clear set of consequences for trustees and enables APRA to focus its powers where there is sustained underperformance of trustee-directed products

Notifications to members

The use of notifications to impress on members that funds are “poor” or “failing” should be reconsidered in the context of performance testing TDPs at an investment option level.

The current wording of the notification is not suited and would be misleading for Choice products. The prescribed wording implies that the member is in an underperforming super fund or superannuation product, rather than an underperforming investment option. This also has flow on impacts, as the rhetoric seems to be that super funds are underperforming, when in fact it may not be the fund as a whole that has underperformed. This unnecessarily generates negative publicity for the industry and erodes the trust that consumers have in their super funds. We do not consider this the right approach for informing members (and their advisers) that a sub-set of their superannuation portfolio has failed a performance test different to the investment option’s specific investment objectives.

We strongly believe better member outcomes would arise from a more balanced approach to disclosure. Trustees are not currently required to report on an investment option’s performance against its specific benchmark (which trustees are required to set under SPS 530). Disclosing this type of information would assist members in understanding the quality of their investment option, including whether it is meeting the investment objectives that they had selected and also to an independent performance test. Implementing improvements to the disclosure framework might be done, for example, through consultation and review of the efficacy of the current MySuper product dashboards regime and how it should be extended to Choice products.

Such an approach would provide for more meaningful disclosure than the current prescribed notice. If the notice requirement is maintained for Choice products, there needs to be scope for the trustee to tailor the wording to suit their business model and ensure it is meaningful for members.

Recommendation

14. Undertake consultation on the best way for superannuation trustees to provide regular, meaningful performance information to members.

4.4. Performance testing other choice products

Consultation question

9. What would be the impact of extending the current performance test to other Choice products? How could any issues be addressed?

We are strongly opposed to extending the current performance test to other Choice products beyond TDPs given the issues that already present with extending the test for TDPs. We provide Government with further detail for each of the three types of non-TDP choice products identified in the Consultation Paper.

Single-sector products

TDPs are defined at an investment option level within a superannuation product. Under the existing performance test approach, a standard MySuper product (which is one investment option) that has underperformance in some asset classes can benefit from offsets caused by overperformance in other asset classes. This would give it a comparative advantage over a portfolio of individual single-sector investment options which are tested individually.

Not all asset classes or investment strategies have a universally accepted benchmark (such as listed infrastructure, property, and to a lesser degree emerging markets and international small cap). This results in an increased amount of idiosyncratic investment risk in the performance of an investment option against a single reference benchmark and would likely increase the chance of failing the test through differences in the benchmark or strategy rather than a failing due to poor investment management.

Examples of single-sector products include:

- Specialised equity strategies – for example, low volatility equities, value/growth style, specific country or area equities (such as European, Asia, China, US)
- Unlisted investment strategies – BMs highly unlikely to be appropriate as often practically impossible to invest in line with the make-up of an unlisted BM
- Protected equity strategies including through the use of derivatives

Even with these examples, we do not believe it will be feasible to add enough new benchmarks to ensure that there are appropriate benchmarks for every single-sector investment strategy and for APRA to collect the necessary data to enable it to apply the performance test.

For example, and in the context of unlisted assets, it is also important to recognise the level of debt used and the amount of liquidity offered to investors when members choose between competing single-sector products. Products which offer more liquidity to investors will tend to be more conservative with their use of debt. A consequence of this is that the more conservative options are likely to underperform funds which take on more debt and/or offer less liquidity – even if the underlying, ungeared returns are identical. For this reason, performance of single-sector products needs to consider objective factors which go beyond one single measurement of performance. A failure to take metrics such as gearing and features such as liquidity into account is likely to produce a systematic bias in favour vehicles utilising higher levels of gearing.

Appropriate performance testing for single-sector products should focus on the investment objectives designed, disclosed and implemented by the trustee, and chosen by the member. This is the objective of SPS 530.

Externally directed products (EDPs)

It would be inappropriate to apply a performance test to investment options for which a superannuation trustee has no control over – for example, platform superannuation products that provide members with access to a wide range of investment options provided by numerous fund managers. For EDPs, the trustee's influence is limited to offering or not offering the underlying product to members.

In the case of platforms, this allows members within the superannuation fund to choose, predominantly through their financial adviser, from an available range of investment options to construct their own individual superannuation portfolio. This system architecture, built on the notion of member choice, has evolved to serve a diverse set of member needs and preferences. It is common for the total number of investment options offered on a trustee's superannuation platform to exceed several hundred.

In our view, the focus of performance testing for EDPs should be more about the process followed when a trustee identifies an underperforming investment option more broadly.

As part of SPS 530, the outcomes of effective performance testing for EDPs can be achieved through focus on the existing investment governance processes and the monitoring that occurs in relation to investment options, such as:

- various actions that are taken for options that underperform benchmarks, including determining when underperforming options will be closed.
- communications to advisers and previously advised clients regarding the closure of investment options.

We would urge caution with the unintended behavioural consequences of extending the performance test to EDPs as this would undermine a level playing field across similar-style superannuation products offered by managed funds:

- members who desire EDPs for their specific investment objectives but can no longer invest in EDPs because it is no longer commercially preferable for the investment manager (the Responsible Entity) to offer managed funds through an APRA-regulated superannuation trustee. These members would move their superannuation to a self-managed superannuation fund (SMSF) to access these investments instead.

- members who manage their superannuation through a separately managed account (SMA) to access the benefits of individualised tax treatment and desire EDPs for their specific investment objectives but it is no longer commercially preferable for the investment manager (the Responsible Entity) to offer their managed fund products through superannuation. These members would no longer be able to invest in EDPs.

Retirement products

It is not appropriate at this time to extend performance testing to investment options supporting superannuation income streams. Extending performance testing, especially in its current form, to superannuation income streams would likely impede innovation. It is critical for members that innovation is supported and encouraged to ensure appropriate, fit for purpose retirement solutions are developed to meet varying retirement needs including those identified in the retirement income covenant - maximising retirement income, managing risks to sustainability and stability of income including longevity, investment and inflation risks, and flexible access to capital. It would likely be difficult for investment options supporting retirement income streams to optimise for these three objectives whilst also passing the performance test.

As noted in the Consultation Paper, retirement products are often designed so that the member does not bear any or all of the investment risk, which means the relevance of the performance test in holding trustees to account on the investment risk borne by the member falls away.

5. YourSuper comparison tool

5.1. General comments

Disclosure plays an important and necessary role in empowering superannuation members to review and engage with their superannuation, particularly within the MySuper market.

5.2. Improving the current tool

Consultation question

10. Does the comparison tool adequately inform members and prompt a behavioural response? Is the tool effective at informing new employees of their options when entering the workforce, including those who do not have an existing superannuation account?

Yes. Anecdotal evidence from FSC's members indicates that the comparison tool has been useful at informing members and prompting a behavioural response.

Consultation question

11. To what extent would altered or additional metrics, or improved functionality, make the tool more effective while ensuring it remains simple and clear? What more can be done to ensure that new employees are able to choose high-performing superannuation product that are appropriate for their needs?

We suggest the current tool be improved in the following areas:

- Allowing for caps on total administration fee levels (currently fee caps are not considered, which results in the display of incorrect fees for members with higher account balances;
- Ensuring consistent calculation of fees between different superannuation products and the need to ensure disclosure of fees in alignment with *ASIC Regulatory Guide 97 Disclosing Fees and Costs in PDSs and Periodic Statements* (**RG 97**);
- Including a clear consumer warning that the 'personalised comparison' only takes into account of the superannuation member's age and current superannuation balance and not other important factors such as insurance coverage; and
- Highlighting any significant changes to the product, such as movement from a single strategy to lifecycle or vice-a-versa. This is currently disclosed in the MySuper product dashboard but there is no indication when viewing the Comparison Tool itself.

Recommendation

15. Ensure the ATO YourSuper comparison tool provides appropriate information to support effective consumer decision-making, including ensuring information is personalised wherever possible and a clear warning for consumers to consider other important areas such as insurance coverage.

5.3. Extension of the comparison tool to more superannuation products

Consultation question

12. As the test is applied to more superannuation products, should the comparison tool also be extended? Considering the volume and complexity of Choice products, how could the tool be extended in a way that is meaningful and digestible to members?

The FSC supports the use of the ATO YourSuper Comparison Tool for MySuper products, as it enables the tool to be kept simple. It makes it an effective first step for consumers who may not be engaged with their superannuation to lean in.

We are opposed to extending the Comparison Tool further.

- Not all Choice products are suitable for all individuals. It is important Choice products in a consumer-facing tool have appropriate guidance.
- Using the tool to compare performance and returns would only be meaningful for comparing like for like individual investment options across funds.
- However, Choice products are generally designed for use in conjunction with the help of a financial adviser who works with an individual to build a portfolio, often combining more than one Choice investment option, that meets their specific needs and goals. Individually crafted portfolios of Choice portfolios cannot be meaningfully compared.
- Direct fee comparisons are less meaningful as the features and functionality for Choice products are not homogenous in the way they are for MySuper products.
- We do not believe it is feasible to include Choice products given the range and number of Choice products (and their underlying investment options) available in the industry without losing the tool's simplicity.

Recommendation

16. Limit the scope of the ATO YourSuper comparison tool to MySuper products.

6. Stapling

6.1. Effectiveness of implementation

Consultation question

14. To what extent are employers putting into practice processes to seek stapled fund details from the ATO? How has the implementation of stapling changed onboarding, software and payroll processes for new employees?

The FSC believes in the principle of superannuation members taking responsibility for their superannuation and exercising an active choice for which fund they want their superannuation to be paid. Anecdotal evidence from FSC members indicates that employers are generally putting the correct processes in place.

6.2. Effectiveness of the current framework

Consultation question

15. Are there any barriers in the current framework to achieve the intent of the stapling reform?

We support the current framework to designate a single stapled product which a member can carry with them until they make an active choice to change. This is the simplest way of achieving the intent of the stapling reforms: to prevent the creation of unintended multiple superannuation accounts when disengaged members change jobs and open a new account by default.

The current framework is consumer centric. It minimises disruption for consumers when they move from job to job when keeping on top of their superannuation affairs. Stapling therefore puts the onus on superannuation funds to demonstrate value to consumers of switching to a competing fund, inherently creating a situation where the benefits to the consumer must outweigh any potential costs before switching. This is not the case for an auto-rollover type model.

In general, the FSC continues to support the use of the tie-breaker rules that form part of existing rules which are currently used by the ATO to enable pro-active consolidation of ATO-held super to a member's active account in instances where an individual holds multiple superannuation accounts.

Given employers and superannuation funds are only just now starting to bed down the recent changes which have not yet been in place for 12 months, we would not support any changes to the regime without a strong and broadly supported evidence base.

Consultation question

16. What is the actual, or likely, impact of stapling on insurance coverage?

When the stapling reforms were introduced, the FSC and its members identified that under these arrangements some consumers may be unable to claim on their life insurance cover because their fund has occupational exclusions and occupation based restrictive disability definitions in the default cover they offer to their members.

To avoid this, the FSC and its life insurance and superannuation members introduced last year an enforceable Standard to end the use of these types of exclusions, which takes effect from 1 January 2023, following a one-year transition period.

- According to FSC analysis, this would remove at least 87 per cent of all occupational exclusions and restrictive disability definitions based on occupational duties that occur in default group life policies found in superannuation.
- Of the remaining 13 per cent, the FSC expects that they will be phased out over the next 12-24 months as FSC life insurance members would no longer propose these types of exclusions when renewing their group policies with superannuation funds.

These activities by the FSC and its members was followed by a Government review undertaken by Treasury.[15] Submissions to the consultation as part of this review completed in October 2021. To clarify the extent to which unintended insurance impacts remain an ongoing issue and to alleviate ongoing concerns held by some industry participants, FSC encourages Government to make the outcomes of this review publicly available.

Recommendation

FSC has completed a review of implementation progress and are satisfied that all FSC superannuation members have commenced their review of existing default insurance arrangements and intend to be compliant with the FSC Standard by next year. With the phasing out of these exclusions and definitions from next year under the FSC Standard, we therefore consider that any changes to the stapling framework for unintended insurance impacts would be unnecessary for industry and consumers.

Insurance for those that choose a superannuation fund

We note that some in the industry might look to raise that the impact that stapling has on reducing the willingness of group insurance providers to offer auto-acceptance for members that choose a superannuation fund. This is an issue that existed before stapling and is not directly related to the implementation or associated outcomes of the YFYS legislation.

Where a person chooses to join a new fund, they cannot by default. They must apply to join the new fund and may also decide to apply for life insurance. In this situation, applying for life insurance would typically be subject to an individual underwriting process that can use occupational exclusions or could mean their application is declined. If so, in line with industry practice, the underwriting outcome will be explained to the applicant who can then decide on whether to take up the life insurance if terms are offered. These practices do not relate to default insurance cover.

[15] See https://treasury.gov.au/consultation/c2021-201055.

7. Best financial interests duty

7.1. Impact on trustees

Consultation question

17. To what extent has the BFID required trustees to change their processes and procedures? Has this caused any unintended consequences or impacted member outcomes in any way?

This measure was subject to considerable debate when first introduced. To inform this debate and provide a neutral basis to interpret the provisions the FSC sought advice from leading financial services lawyer, Michael Vrisakis, Partner at Herbert Smith Freehills. The advice is attached to this submission.

The FSC position has not changed and continues to reflect the advice from Mr Vrisakis: that the amendments are less contentious and material than they appear, as the amendments do not change the substance of the law. Conduct that was previously unlawful remains unlawful, but the wording of the primary legislation is clarified to make this explicit. Moreover, these reforms operate in a way that is agnostic to different corporate structures and apply evenly to all superannuation funds. This ensures consumers across the industry are protected from misuse of their savings. The FSC supports this approach.

In the absence of demonstrable evidence of significant adverse unintended consequences following the introduction of BFID, the FSC is opposed to any changes to the current duty and is of the view that the current policy settings are appropriate.

7.2. Scope of application

Consultation question

18. Are there certain types of expenditure or activity that trustees are particularly concerned about being able to prove compliance with the BFID in respect of? Why is it difficult to demonstrate compliance? Should there be a materiality threshold?

We are opposed to introducing a materiality threshold. Superannuation trustees should be able to demonstrate that the decisions are promoting their members' best financial interest. Simply excluding this requirement for expenditure or activity below an arbitrary threshold would be inconsistent with this obligation and introduces unnecessary complexity to the regime.

A number of FSC members have observed the administrative burden of applying this framework in practice and that there could be room for improvement. This primarily arises the risk of differing legal interpretation as to whether the new duty would have the effect of changing the scope of application where BFID applies (our understanding based on the advice from Mr Vrisakis is that the new duty does not change the scope of application). We observe that this risk will naturally reduce in time as this new duty becomes more familiar and consistently interpreted by industry participants. Given the changes have only been in place for slightly over one year, it is difficult to fully separate out the implementation cost versus ongoing cost.

In relation to the deduction of ongoing advice fees from a member's superannuation account, there is some uncertainty amongst industry as to whether the Best Financial Interest duty and/or the Sole Purpose Test is relevant. On the basis that it is, this requires the trustee to have in place appropriate monitoring of advice fees that are deducted from a member's account. However, under the advice regulatory framework, an entirely separate set of obligations apply even though many of these are similar. This is additional to further frameworks overlaying the determination of a product's suitability such as the Design and Distribution obligations. This issue is being considered by Government's Quality of Advice Review that is currently on foot and we are supportive of the direction expressed in the recent Proposal Paper that has recently closed for consultation.[16]

Recommendation

17. Provide further guidance around the scope of application for the Best Financial Interest Duty in the following areas:
    - expenditure that the trustee or service providers take from their own assets are not covered by the duty; and
    - the deduction of ongoing advice fees from a member's superannuation account.

7.3. Reverse onus of proof

Consultation question

19. Is the reverse onus of proof the most appropriate way to achieve the objective of improving member outcomes?

Based on the advice from Mr Vrisakis, the FSC understands that, provided a trustee and a fund's directors can provide evidence that they have exercised their powers in the best financial interests of fund members the onus still falls on the regulator to then prove that they did not.

The reversal in the onus of proof now requiring a trustee to retain and provide evidence to demonstrate that expenditure is in the best financial interests of its members is appropriate in the context of our mandatory superannuation system, which lends itself to a higher level of member disengagement.

The FSC believes these changes have been positive as they have help empower APRA to take action in relation to breaches of these provisions as the reversal of the evidentiary burden addresses information asymmetries, where a trustee knows the basis for a decision whilst the regulator may not have access to that information.

[16] See Section 3.3 of the Quality of Advice Review: Consultation Paper – Proposals for Reform, accessed at https://treasury.gov.au/sites/default/files/2022-08/c2022-307409-proposalsp.pdf.