FSC FINANCIAL SERVICES COUNCIL

Luke Spear
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The Treasury
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Via email: yfys@treasury.gov.au

Dear Mr Spear

RE: Annual Superannuation Performance Test – design options: Consultation paper

The Financial Services Council (FSC) welcomes the opportunity to make a submission in relation to the Government's review of the operation of the annual performance test. The FSC has supported the performance test in ensuring member outcomes are protected from underperformance leading Australians to be in a stronger financial position to fund their retirement. The performance test to date has had many achievements through both directly pushing underperformers to merge with higher performing funds, but also pre-emptively encouraging funds to actively consolidate to assist in generating better financial outcomes for their members and reducing fees across the industry.

The consultation does not provide a strong base for why the current test does not achieve its goal of enhancing member outcomes and delivering a better retirement for Australians. While it raises the issue of 'benchmark hugging' it does not provide an evidence base nor articulate whether returns for members would be better if trustees did not attempt to perform to and beat the defined market benchmarks.

The consultation also raises issues around being restrictive for some investments, but also does not back this up with evidence of why the performance test, as it stands, is the main driver of these investment decisions. There are several factors that inform a trustee's investment decisions, namely that investments need to be in the best financial interest of members. Some of these 'new and emerging' asset classes may not be able to satisfy that test, whether the performance test was applied to them or not. The Government could consider setting a tailored threshold for these asset types if there is a genuine concern of a barrier to investing in certain asset types.

The FSC remains confident in the strong, current approach to the Government's performance test which has been proven to promote market consolidation, reduce fees and ultimately deliver better outcomes for members. However, there is scope to make some adjustments to the current design to enhance the test further and ensure the test works appropriately through assessing the benchmarks included for the test, clarifying the definition of trustee directed products (TDPs), adjusting fee parameters, and introducing a product modernisation regime to allow for further consolidation.

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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, and financial advice licensees.

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.

Summary of Recommendations

1. The principles to recognise the importance of choice and competition in achieving improved member outcomes, including recognising the inherent differences in products offered on the market;
2. The principles to acknowledge that the performance test should take into account the structure and product types when being applied. This would allow continuous innovation in products and provide members more choice of how to invest their retirement savings;
3. Adopt option 1, Status quo – SAA Benchmark Portfolio, from the consultation paper to ensure industry is continued to be held to account and member's outcomes are continuing to be improved;
4. Assess the current benchmarks and include suggested benchmarks in line with the suggestions outlined in the submission, on a prospective basis, to allow for lower degrees of tracking error in a range of different investments;
5. A review be conducted into the pricing of the prescribed benchmarks by index providers to ensure they are not abusing their position as a monopoly provider of indices;
6. Introduce a formal tri-annual review of the benchmarks included in the performance test, ran by APRA, to ensure relevance of current benchmarks as well as to prospectively introduce any new benchmarks that may enhance the test;
7. The allowance of a for new general benchmark for new and emerging assets that do not align to any of the prescribed benchmarks for assets invested on a prospective basis, tested against a basic CPI+X%, where 'X' is to be determined by Treasury based on market conditions, test to provide additional flexibility for fund's investment decisions until an appropriate benchmark is adopted;
8. The performance test should not change to the proposed single-metrics to determine if a fund is delivering for their members, as they would have significant unintended consequences which could lead to sub-optimal member outcomes;
9. The performance test continues to hold industry to account for achieving member outcomes by not introducing additional 'lifeline' metrics to the test;
10. Do not expand the performance test to cover retirement products at this stage due to

the risk of stifling innovation while products are being developed and the need to ensure a stable accumulation performance test before significantly expanding the test's remit;

11. Clarify the application of the Trustee Directed Product definition to ensure externally directed products, where the trustee has no control or influence over the investment strategy, are not captured;
12. Fees for platform products should be measured at the product level and apportioned to options accordingly to more accurately reflect the fees being paid by members for the product they are in;
13. Update the representative member balance of $50,000 to the median balance for each product cohort, clearly defined to include MySuper, Non-platform TDP and Platform TDP;
14. It is important that the performance test continues to have a forward-looking component through the use of current fees when calculating investment performance on funds to ensure member outcomes are protected through maintaining lower fees;
15. The consequences to be updated to reflect the active choice nature of TDPs to better address the underlying performance issues of products through working closer with APRA to develop an action plan to address underperformance;
16. The performance test to consider instances where a client has an agreed approach with an adviser to develop a holistic investment strategy enabled by a Platform when applying consequences, such as amending notification requirements to prompt advised members to discuss their portfolio with their adviser;
17. Adopt a product modernisation regime to allow members to move to more efficient, higher return products without facing tax consequences; and
18. Allow for performance history stitching to not occur when underperforming products roll into better performing products as a result of underperformance, to reduce the risk of the performance of the successor being impacted.

Options for reform

Do you agree with these principles? Are there any other principles that should be considered?

The FSC broadly agrees with the principles presented in the paper, the test should first and foremost aim to deliver improved outcomes for members through ensuring products on the market are of high quality while not creating barriers for trustees to invest in, or provide members with options to invest in new and innovative ways that could deliver good returns. While it is important that only products that deliver good returns should be offered to members, it is vital that customer choice and competition are a factor in these decisions. There may be a multitude of reasons why a member (or their advisor) chooses to include a particular product to form part of their portfolio, which may also be a factor in improving their retirement outcomes.

While it is important that the test captures a range of superannuation products to ensure member outcomes are protected, the FSC and its members would like to see consideration of the intrinsic differences of product offerings in how the test is applied, such as through a

more tailored consequence framework. MySuper products are default products and often have little to no engagement from members and therefore the test, and how it is currently applied is suitable to ensuring members in these products are shielded from being placed by default into a sub-par product. Conversely, a member or their adviser has to make an active decision to elect choice products, particularly platform products, which shows a level of active engagement by the member. Furthermore, these products are often more complex and can be included in a broader portfolio strategy or are chosen for other personal preferences, meaning some choice products may not be directly comparable to MySuper or other simple choice products.

RECOMMENDATION 1

The principles to recognise the importance of choice and competition in achieving improved member outcomes, including recognising the inherent differences in products offered on the market.

Further to this, while it is important to capture as many products as possible, it is also important to consider what products are currently appropriate to test. The current market offers many options for how someone can invest their retirement savings and the test currently captures a large portion of these options. As such, an optimal performance test would not be a one-size-fits-all approach, but would recognise the differences in the structure of products when testing them. Applying the same test across industry leads to a lack of innovation and variety in the types of products available for members, this could ultimately lead to poorer member outcomes.

RECOMMENDATION 2

The principles to acknowledge that the performance test should take into account the structure and product types when being applied. This would allow continuous innovation in products and provide members more choice of how to invest their retirement savings.

Status quo – SAA Benchmark Portfolio

Is assessing the implementation of a strategy, as opposed to assessing the choice of strategy itself, a strength or weakness of the current framework?

While assessing the choice of strategy could be an effective way to test the performance of funds, it is more difficult to compare and apply a pass or fail mark to, as there are a multitude of factors that should be considered when testing a choice of strategy. When testing the choice of strategy, factors such as the level of risk a member is willing to take, whether an individual has a preference for particular asset classes, or a particular fund's access to off-market assets can all be difficult to assess overall performance on. To apply an accurate and effective means of assessing a fund's choice of strategy, there would have to be an element of subjectivity from ether the Government or APRA. This subjectivity would be significantly resource intensive for both the industry and taxpayer, this would open the assessment up to greater scrutiny and dispute, ultimately undermining the objective. Members could then be trapped in underperforming funds while disputes or legal proceedings are taking place.

The current method of testing the implementation of a strategy allows for a test that can be applied equally across industry and is a clearer way to explain how well a fund is able to provide returns for members on asset types of the same or similar risk levels, distilled to a

simple ‘pass’ or ‘fail’ result which a member can easily digest. That is, it answers the question members would have, is my super fund achieving the rates of return I should expect for the assets my super is invested in?

For the purpose of the performance test, to improve member outcomes and protect members from being offered objectively poor products, the current method of testing the implementation of a funds strategic asset allocation is a strength. It is clear whether a fund has passed or failed, it is purely objective and is appropriate for identifying any implementation underperformance which has been proven over the last three years of the test, which has seen 1.4 million MySuper member accounts (containing $75.5 billion of assets) being moved to higher performing MySuper products.

RECOMMENDATION 3

Adopt option 1, *Status quo – SAA Benchmark Portfolio*, from the consultation paper to ensure industry is continued to be held to account and member’s outcomes are continuing to be improved.

Can the existing methodology be materially improved, such as by further calibrating benchmarks, to largely address unintended consequences? How could these improvements overcome the incentive to benchmark hug, and remove barriers to invest in emerging asset classes?

Do you consider additional indices covering additional asset classes should be added to the test?

Whilst the performance test has been largely successful in its current form, there is room for improvement in the way the test is applied that would also assist in addressing the policy issues raised in the consultation paper. Having a broader range of benchmarks would be the easiest enhancement for the test. The FSC, in our 2022 submission, provided Treasury with a number of recommended benchmarks that would allow for a wider range of investments for trustees. Investments and investment strategies that introduce tracking error to the currently assigned benchmarks are discouraged because of the performance test risk this introduces to portfolios.

Specific examples of discouraged investments and investment strategies include smaller companies equities strategies, defensive low-volatility strategies within asset classes, inflation-linked bonds, floating rate debt strategies, tail risk hedging strategies and defensive alternative asset strategies.

The FSC thanks the Government for the addition of several benchmarks for the 2023 performance test, but also have included recommendations in relation to benchmarks at Attachment A: Assessment of Benchmarks which would assist in reducing the tracking error currently faced by some investments.

RECOMMENDATION 4

Assess the current benchmarks and include suggested benchmarks in line with the suggestions outlined in the submission, on a prospective basis, to allow for lower degrees of tracking error in a range of different investments.

Whilst the SAA benchmark test is the most appropriate design option presented in the consultation, the FSC would also like to raise concerns raised by FSC members with the costs associated with accessing the prescribed benchmarks. As the benchmarks set out in the regulations are independently owned by companies such as MSCI and Bloomberg, there

are costs associated with trustee's accessing these benchmarks to assess themselves and ensuring they are performing well and in line with performance test expectations. This has created a monopoly for the specific benchmarks prescribed in the test, as each index provider is the sole owner of the required benchmark, which has led to extremely high costs in some circumstances.

For example, MSCI has quoted one of their benchmarks added for the 2023 performance test, *MSCI Global (Excl. Pan Europe and Pan Asia Funds) Quarterly Property Fund Index (Unfrozen) (Net Total Return; AUD fixed),* to be US$50,000 for access by an FSC member. This cost, especially when factoring the number of benchmarks included in the test, is extremely high and will ultimately be borne by members.

RECOMMENDATION 5

A review be conducted into the pricing of the prescribed benchmarks by index providers to ensure they are not abusing their position as a monopoly provider of indices.

To assist in the maintenance of the benchmarks in the performance test, the Government could include a regular tri-annual review of the benchmarks included in the performance test. The governance of the benchmarks could be moved from the SIS regulations and included in an instrument issued by APRA who could then be responsible for running the review. APRA, as the regulator who runs the performance test and is in constant contact with trustees, is best placed to run a targeted review of the benchmarks, which would include the appropriateness of current benchmarks and the need for addition of new benchmarks based on industry investment practices. This streamlined review would also allow for a consultation solely about ensuring the benchmarks are best for the test where any further broader consultations around the performance test will be at the discretion of the Government.

RECOMMENDATION 6

Introduce a formal tri-annual review of the benchmarks included in the performance test, ran by APRA, to ensure relevance of current benchmarks as well as to prospectively introduce any new benchmarks that may enhance the test.

Using a CPI+X% benchmark for new and emerging asset classes

The consultation raises the issue of the performance test currently inhibiting new emerging asset classes, which is largely due to the tracking error associated with these asset types and the available benchmarks the test is applied against. Having a CPI+X% test applied to these identified asset types as a general benchmark would allow trustees more flexibility in their investment choices, including into emerging assets such as some types of ESG investments, without having to ensure they are aligned to the available selection of benchmarks.

There may be challenges with selecting the 'X%' amount, but this could be flexibly adjusted through the regulations and be selected based on market factors. The Government can choose an appropriate amount that would both provide members with sufficient returns, whilst not deterring investments in emerging asset classes. Other safeguards should also be put in place, such as a cap on the amount of assets (eg. 5% of FUM) can be included in the benchmark. It would only be appropriate to allocate assets to this 'general benchmark' on a

go forward basis, that is, current investments should not be allowed to be re-allocated. The trustee must also be able to demonstrate to the regulator that assets attributed to the general benchmark do not align to any of the specified benchmarks.

RECOMMENDATION 7

The allowance of a for new general benchmark for new and emerging assets that do not align to any of the prescribed benchmarks for assets invested on a prospective basis, tested against a basic CPI+X%, where 'X' is to be determined by Treasury based on market conditions, test to provide additional flexibility for fund's investment decisions until an appropriate benchmark is adopted.

Would retaining the current framework but moving to a simpler structure, such as a simple-reference portfolio of only bonds and equities, address some of the concerns with the current test?

Moving to a simpler structure may in theory address concerns of tracking error and capturing assets that would not fit a prescribed benchmark, but in practice this would have several consequences. Firstly, it is stated within the principles that the test should be objective, moving to a simple reference portfolio would add a large degree of subjectivity when classifying assets as equity/growth bond/defensive. Not all assets are clear cut, and would lead to challenges and gaming of the system. Using standard deviation as a proxy for risk would also be fraught with challenge (see alternative single-metric test section below). Maintaining a wide range of benchmarks whilst providing a framework for a general benchmark would provide a wholistic test that would allow a fund to have more freedom to invest in the best way to maximise returns for their members.

Alternative single-metric test – Risk-adjusted returns

Would the Sharpe ratio be a more appropriate testing approach than the current framework? Would this lead to better member outcomes?

What incentives would these alternative single-metric options provide trustees, and what would be the consequence of this for member outcomes?

Sharpe ratio (Option 2a)

The consultation paper does well to explain how the Sharpe ratio could be used to apply a performance test to funds and how it may work mitigate some of the policy issues raised in the paper. While it may seem like a simple approach, there are many inherent issues with only using a single factor to measure performance against funds which are diverse in nature. This would likely drive funds to have very similar methodologies for how they strategise their investments which would be detrimental to the variety in funds currently available across the MySuper and choice sectors. Particularly with the Sharpe ratio which would likely drive funds to only focus on volatility. This could therefore lead to poorer member outcomes through lower returns in the long run.

The consultation paper also raises many of the issues that would come with a variation-style performance metric. This includes fund behaviour towards valuations, where assets that are less-frequently valued (such as unlisted assets) would have a lower standard deviation and be seen to be as a lower risk asset, where in many cases, this is not true. A performance

test of this nature would likely drive more funds towards unlisted and other types of less frequently valued assets which would further exacerbate current challenges APRA has called out with unlisted asset valuations along with liquidity management risks. Standards around valuations would need to be significantly enhanced to include more regular valuations (including use of time-series valuations when appropriate), independent valuations that are benchmarked across industry (to avoid large differences in the way the same asset is valued by different funds), and enhanced regulation by APRA. Liquidity management could also prove to be difficult with the push into unlisted assets which are generally considered longer term, capital investments. This would all come at a great cost to members of funds and the taxpayer and could also have an overall negative impact on returns as funds would incentivised to invest more into unlisted and less frequently valued assets, even if there are available investments with better return outcomes for a similar level of risk.

Further to this, the consultation also states correctly that the Sharpe ratio is agnostic to the type of volatility an asset exhibits (whether it be upside or downside). This could lead to discouraging funds to invest in assets that have a high total volatility, even if it is on the upside. In this situation, it is also possible for the test to provide false negatives as such, if a product has a large upside volatility, it is not representative of the risk a fund is taking in relation to the return that is being made. This could be detrimental to member outcomes as an otherwise well-performing products could fail the test, and would have to face the consequences, when in fact, the fund has been performing as intended.

Are either of these approaches better than the existing test methodology (Option 1) or a simple Sharpe ratio (Option 2a)? Are there any other considerations that make this a better or worse option?

Peer comparison of risk-adjusted returns (Option 2b)

Whilst some of the issues in the Sharpe ratio methodology could be alleviated though a peer comparison, there are many issues that would arise when using a peer comparison. Firstly, Australia has a diverse range of products, particularly in the choice sector, whereby it could be difficult to have an agreed upon comparison for particular products and in many instances it would be comparing apples with oranges. As stated above, it would not make sense to use volatility for a measure of risk. Noting the consultation presents the notion of using *strategic growth asset allocation*, this would be extremely difficult to enforce and require a large degree of subjectivity from the Government or regulator for what would constitute a growth asset. The Government could pursue the use of the historical *ex-ante* (20-year forward looking) standard risk measure per the product disclosure statement at the time as a more objective measure. Furthermore, a test of this kind will always produce fails (relative to peers), which would eventually lead to the potential oligopolisation or monopolisation of the current market which provides members with a diverse range of products and options.

Risk-adjusted returns relative to a simple-reference portfolio (SRP) frontier (Option 2c)

While the FSC notes the perceived benefits of the SRP method of testing, it is important to consider potential issues that could arise which are largely synonymous with the former single-metric options presented in the consultation paper. Risk is continued to be measured through standard deviation which, as mentioned earlier, would not accurately measure the true risk for many asset types.

Whilst the FSC appreciates the level of detail provided in the single-metric options provided in the consultation paper, however, there are many unresolved issues that would lead to the options having adverse impacts through incentivising industry towards investing in assets with low volatility, or assets with a high level of subjective valuations. These methods may also have a higher degree of a false failure through anomalies in the way a peer comparison or volatility-based risk is calculated. The FSC continues to recommend option 1 with the recommended changes as the most viable way forward as the inclusion of several benchmarks can be applied fairly across industry and is better tailored to how each of the prescribed benchmark asset classes act and change with the market, where assets with large tracking error could be allocated to the aforementioned general benchmark.

RECOMMENDATION 8

The performance test should not change to the proposed single-metrics to determine if a fund is delivering for their members, as they would have significant unintended consequences which could lead to sub-optimal member outcomes.

Multi-metric test

Alignment with the APRA heatmap

Would greater alignment to the APRA heatmaps improve the sophistication of the test?

APRA heatmaps provide useful information to industry and the wider market which is a tool that can be used by advisers and members to assess and compare products against a range of eight different metrics which the user can prioritise themselves. Alignment to the APRA heatmaps would increase the sophistication of the test as the heatmaps contain eight different data points of comparison. Whilst the sophistication of the test would be enhanced, the operation and understanding of the test would grow in complexity.

The FSC is supportive of APRA's current project to align the timing of the performance test and heatmap data which will provide greater certainty for industry and reduce confusion for members. Whilst there is much useful information included in APRA's heatmap, not all metrics would be suitable for testing in the performance test. The SAA metrics would be suitable in line with the 'status quo' test and some room for enhancement could be to incorporate an additional look-back period, such as the 5-year is shown in the heatmap, into the test. There would likely be complications with the inclusion of the simple reference portfolio as explained above. This would also lead to issues of allocating assets between defensive and growth. Further to this, including both metrics would lead to confusion as one would need to be prioritised over the other to perform the test in a way that would not be perceived to be 'weakening' the test. The further fee-related metrics of the APRA heatmap could also be used alongside the test but should not be tested separately. The performance test currently captures the impact of fees through returns for investment fees and as a net result for administration fees, this approach has seen a significant decline of administration fees across industry since the inception of the performance test.

There would also be great difficulty on how to provide a pass or a fail based on the large amount of metrics and what benchmarks for each metric would be used to determine a pass or fail. The test could continue to use the SAA benchmarks to test products on and then use the additional information to provide members with a more holistic understanding of how

their superannuation is performing. It is also important to consider that the results of the test must be clearly communicated to members. APRA's heatmaps are quite complex and therefore would be more difficult to explain why a particular product has failed to a member, especially if using multiple complex metrics.

The FSC also shares the Government's view that the performance test should not be 'watered down' and including a multi-metric test in which only one metric needs to pass would be a significant loosening of the test. There would be many instances where a product or investment option could fail one test and pass the other, this would inherently see a decrease in member outcomes as products or options that would otherwise fail could slip through the cracks.

Targeted three-metric test

Would this framework improve the sophistication of the test? Would it reduce incentives to hug benchmarks and improve member outcomes?

Including additional metrics in the performance test may have the face-value of improving the sophistication of the test, it will increase the complexity of the test and could lead to a much easier test to pass which would see a reduction in member outcomes across industry.

Both approaches shown in the consultation paper, the majority fail and the hierarchical fail, add additional layers of complexity whilst also significantly minimising the efficacy of the performance test. Both options provide funds with an additional lifeline unnecessarily, the current test has shown to be effective in identifying underperformance and has enhanced the retirements of over a million Australians. Further to this, the issues raised in the consultation paper would likely continue to persist with either of the multi-metric options.

The FSC would also like to further raise concerns with the majority fail approach in the consultation paper. This methodology puts equal weighting to each metric, when in matter of fact, this is not the case. This could see a fund that has obscenely high fees but slightly above average performance passing the test. It is important that member outcomes are maximised through the performance test through assessing all aspects of a funds performance together as is done with the current performance test.

RECOMMENDATION 9

The performance test continues to hold industry to account for achieving member outcomes by not introducing additional 'lifeline' metrics to the test.

Scope of the test

What are the most important considerations for performance of retirement products?

The FSC is not supportive of introducing a performance test on retirement products. Retirement products are inherently non-comparable because they offer such a wide variety of benefits and additions. Those benefits and additions are part of a package that includes investment performance and the varying make up of these packages make them hard to equate across the market.

The results of any performance test may unreasonably influence people to make rash

decisions about their retirement products, which may lead to poor member outcomes if they switch away from a product that suited their needs (and perhaps they had already sought financial advice on).

Any performance test introduced on retirement products will also likely stifle innovation. It is important that trustees are able to develop an array of different retirement products that may suit people to their own individual needs. While a simple account-based pension may be right for some retirees, others may want to hedge their longevity risk through an annuity and others may wish for a combination of both types of product.

Further to this, the Government is still looking to further develop the current performance test for accumulation products. The FSC believes that expansion beyond accumulation products should only be investigated upon the development of a fully functional accumulation performance test.

RECOMMENDATION 10

Do not expand the performance test to cover retirement products at this stage due to the risk of stifling innovation while products are being developed and the need to ensure a stable accumulation performance test before significantly expanding the test's remit.

Do you agree that the 'other products' outlined above are unsuitable for testing? If you think the 'other products' (or a sub-section of these products) are suitable for testing, how could they be appropriately tested?

The FSC notes that the current definition of trustee-directed products captures underlying accessible investments provided by a related-entity of a fund, but not all externally directed products (EDPs). The FSC continues to submit that these products should not be captured by the test if the policy intent is to not capture all EDPs, the related entity relationship does not translate to the trustee having any control over the performance or fees of the product being tested and as such, should be seen as an EDP where the trustee's influence is limited to offering or not offering the underlying product to members.

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.

In the case of platforms, this allows members within the superannuation fund to choose, predominantly through their financial adviser, from an available range of underlying accessible investments 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 underlying accessible investments offered on a trustee's superannuation platform to exceed several hundred.

In the FSC's view, the focus of performance testing for EDPs should be more about the

process followed when a trustee identifies an underperforming underlying accessible 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 underlying accessible 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 underlying accessible investment options.

RECOMMENDATION 11

Clarify the application of the Trustee Directed Product definition to ensure externally directed products, where the trustee has no control or influence over the investment strategy, are not captured.

Fees

Should fees be measured at the current option level, or should they be measured on a different level? How would this be achieved?

Fees currently measured at the option level is an effective means to compare and measure fees in MySuper and other simple choice funds, as in these cases there is often only the one set of fees for administration. However, the platform choice market is far more complex as there are often multiple pathways and layers of fees. A member of a platform product would have fees for both the platform and separately, the investment options. In order to best assess the investment option, which is captured by the test, the fees associated with the platform must be apportioned in a way that is reflective of the members experience. Currently there are several instances where fees attributable to a particular pathway for members are unrealistic and overly inflated.

This could be resolved by looking at total fees at the platform level and apportioning appropriately to investment options. This would provide a more realistic approach for calculating fees for platform products.

RECOMMENDATION 12

Fees for platform products should be measured at the product level and apportioned to options accordingly to more accurately reflect the fees being paid by members for the product they are in.

Are the current assumptions made in comparing fees acceptable? For example, should the $50,000 representative member balance be adjusted based on the median member balance for a product cohort?

When the performance test was first applied, a simple $50,000 representative member balance was appropriate for MySuper products and reflected the market at the time of the tests inception. As member's superannuation balances have grown, this representative

member has become less realistic and significantly understated. The FSC supports an increase of the representative member fee to an amount that is more reflective of today's market. Using the median superannuation member balance for product cohorts would look to achieve this, as this would ensure that the representative member grows with member's balances.

Further to this, it is highly important that product cohorts are defined correctly when selecting a representative fund member balance. MySuper would be a simple case of a product cohort, but it is also important to split up choice products offered on platforms and non-platform TDPs due to the nature of how fees are changed. There are currently instances where platforms have minimum asset requirements that are higher than the $50,000 representative member, which means that the test of fees for this product does not make any sense. Further to this, due to how a platform operates, there are instances where fees charged become lower with higher member balances which demonstrates that the performance test is currently not accurately capturing the member's experience and hence could be producing false fail results.

RECOMMENDATION 13

Update the representative member balance of $50,000 to the median balance for each product cohort, clearly defined to include MySuper, Non-platform TDP and Platform TDP.

How many years of fees data is appropriate to test? Should a greater weighting be given to certain years?

As stated in the consultation paper, there has been clear evidence that demonstrates the current approach has been successful in lowering fees across the superannuation industry. Superannuation fees have fallen to 0.93% per annum which has been the lowest total expense ratio on record.[1] It is important that the performance test continues to have a forward-looking component, by incorporating current fees into the performance calculation, it is influencing fees to be lower on a go forward basis which has been and will continue to improve member outcomes through lower administration fees.

The use of current fees has additionally created a strong incentive for funds to reduce their fees for members, and the evidence shows that the median administration fee for a $50,000 representative member of MySuper products has fallen from 0.33 per cent in 2021 to 0.26 per cent as of June 2023. Since the inception of the performance test fees have fallen in both MySuper and ranges of Choice products. There has been no evidence to suggest that the lower administration fees has created an inoperable environment for trustees, where many of FSC's members have been able to keep their fees low while still offering high levels of customer service.

Historical fee data has not been collected by APRA for the lookback periods that would be required. This data would need to be provided from industry which would create additional burden and be difficult in some circumstances where performance histories have been stitched.

Moving to include historical fees would also have perverse outcomes and without the forward-looking test on fees, could lead to trustees increasing fees, knowing that their current year fees would only have a minimal impact on test as it is averaged out over a long time-period. This consequence could ultimately cost members millions of dollars in increased fees, if the incentive to keep current fees low is removed. Historical fees could also

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[1] https://www.rainmaker.com.au/media-release/super-fund-fees-fall-to-record-low

adversely impact trustees who have had higher historical fees, even if they have been able to lower fees for members in recent years. This adverse impact may lead to funds that are currently charging low fees with good performance to fail a test due to historical factors that are out of the fund's control and also have no impact on member outcomes of the fund going forward.

In order for the performance test to achieve its goal of providing better member outcomes and an enhanced retirement for Australians, it needs to keep a component of the test that drives better performance on a go-forward basis which can be achieved through maintaining current fees in the calculation of performance.

RECOMMENDATION 14

It is important that the performance test continues to have a forward-looking component through the use of current fees when calculating investment performance on funds to ensure member outcomes are protected through maintaining lower fees.

Consequences

Should the consequences be adjusted to improve outcomes for members? How would this need to be tailored for the different options for performance testing?

The FSC supports the current consequence framework in the context of the default MySuper product market, were members have a lower level of engagement and require a higher degree of Government involvement to ensure they are placed in a suitable product. However, the choice sector, by nature, requires members to be more engaged and actively involved in their product selection.

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.

The FSC would like to 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 they are 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 15

The consequences to be updated to reflect the active choice nature of TDPs to better address the underlying performance issues of products through working closer with APRA to develop an action plan to address underperformance.

Unintended consequences in applying the performance test to advised members

To illustrate the potential impact (and poor member outcomes) where the performance test is applied to a professionally advised and individually tailored investment strategy implemented via a Platform, we used an example where the client requires an Australian equities exposure that utilises two different active managers with different investment styles – "value" and "growth". The benefit of the blending is to achieve a better risk adjusted return through diversification across different managers and investment styles while also aiming to outperform the index.

The table below shows the annual performance returns over 10 years from end September 2013 to end September 2023 for each specialist manager selected, the performance from a combination of a 50/50 blend and the performance of the benchmark (S&P/ASX 200 Total Return). In the example, the value manager underperformed the index for the three years from Year 5 to Year 7. If the value manager had failed the performance test and was required to be removed from the investment menu, then the client would have missed the significant outperformance the following year plus lost the diversification benefits of this blend.

The application of a performance test on each fund also does not consider if the portfolio was delivering to the investor's risk and return objective which, in this case, may have been to achieve benchmark returns with lower volatility.

Yealy returns Oct 2013-Oct 2023	Growth manager return	Value manager return	Index return (S&P/ ASX 200 Total Return)	50/50 growth and value return
Year 1	8.14%	6.24%	6.39%	7.19%
Year 2	7.97%	1.35%	-0.74%	4.68%
Year 3	7.38%	4.92%	6.11%	6.20%
Year 4	9.90%	23.52%	16.13%	16.37%
Year 5	5.38%	-2.49%	2.94%	1.41%
Year 6	23.50%	12.00%	19.28%	17.93%
Year 7	26.84%	-20.49%	-8.15%	5.05%
Year 8	31.36%	38.74%	27.96%	33.93%
Year 9	-27.71%	1.86%	-2.01%	-17.04%

Year 10	3.57%	2.98%	7.12%	3.30%
Total return annualised	**9.63%**	**6.86%**	**7.50%**	**7.90%**

Other examples where applying a performance test to the individual components of a holistic investment strategy implemented via a Platform could have poor member outcomes include:

- **Allocations to higher risk funds where performance is more volatile:** The member may have invested in these types of funds with a small portion of their overall wealth for a return premium that may take time to materialise. Examples are specialised funds (where currently only 'connected entity' options are captured by the test) with exposure to sectors like technology, or to emerging and regional markets. The performance test does not consider the role of these funds in the overall investment strategy chosen by the member under professional personal advice.
- **Use of funds focused on different sectors of asset classes for specific client reasons:** For example, a member with a large Australian share exposure may prefer to orientate their international share exposures to funds with limited holdings in resources and financial services companies given the higher exposure to these sectors in their Australian share holdings. Or perhaps the member has large personal shareholdings in Australian resource and banking stocks, through their employment or personal share purchases, and consequently have worked with their adviser to bias their superannuation portfolio exposures to other asset classes and share market sectors to create a more diversified overall investment strategy. There may be funds in these types of investment strategies that underperform for a period. However, a wholistic view of the investment strategy may match the client's risk and return objectives.

The current consequence framework can create significant confusion with clients of advisers in the way in which a 'fail' notification is issued. It may have been a specific strategy formulated between an adviser and their client tailored to individual needs. The performance test is also applied in a way that might not capture the fees a client is paying accurately and therefore may be misleading. Notifications for members who are advised should prompt a member to discuss the underlying accessible investment which has failed the test to ensure the member is making an informed decision about the product and is considering this in the context of their wider superannuation investment portfolio leading to improved member outcomes.

Recommendation 16

The performance test to consider instances where a client has an agreed approach with an adviser to develop a holistic investment strategy enabled by a Platform when applying consequences, such as amending notification requirements to prompt advised members to discuss their portfolio with their adviser.

Barriers to consolidation

Are there any key barriers to consolidating closed and underperforming products? What quantitative evidence is there of these barriers? How do these weigh against other reasons a person may choose to remain in a product?

In November, 2023 the FSC released research showing clear benefits that would be produced under a product modernisation regime.[2] A product modernisation framework would also strengthen the Government's medium and long-term fiscal position by almost $1 billion over the next 10 years, and $21 billion by 2050, comprised of:

- Additional Government revenue of $2 billion by 2050 through additional superannuation tax receipts, with $700 million of the revenue realised in the next 10 years; and
- A reduction of $19 billion in Age Pension outlays by 2050, with $240 million of these social security savings delivered within the next 10 years, as retirees benefit from higher superannuation balances.

The FSC would particularly like to raise 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 of consolidation in the Choice sector.

Importantly, permanent CGT rollover relief 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 consolidation of choice 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 their own assessment or the result of 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 which would therefore mean a transfer is unlikely to be in the best financial interest of the impacted members.

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.

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[2] https://fsc.org.au/resources/2675-product-modernisation-research-report-2023/file

Further to this, the FSC's research conducted by EY included key expected outcomes of product modernisation, across four key stakeholders, these include:

- **Benefits to Members** - including access to equivalent products with higher net investment returns driven by both higher expected investment performance and lower fee structures.
- **Benefits to Government** - through greater tax receipts and savings due to reduced aged pension payments
- **Benefits to Trustees -** through operational and administrative efficiencies; and
- **Benefits to Regulators** - through a more competitive industry driving better outcomes for the member thanks to operational efficiencies.

More generally a product modernisation regime should be implemented that would include:

- 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.

RECOMMENDATION 17

Adopt a product modernisation regime to allow members to move to more efficient, higher return products without facing tax consequences.

An additional barrier to consolidation is the stitching of performance history of closed or retired investment options when these are rolled into a new option or fund. Currently when a fund is rolled over into another fund, the performance history is stitched into the successor fund. This has perverse consequences as a processor fund may be rolling over due to underperformance and is likely to be rolled into a better performing fund. In the current system, this fund would be 'dragged down' in future performance tests due to the stitching requirements. This creates a barrier to rolling underperforming investment options into better performing investment options, even if it is in the best financial interests of members to do so, as this could result in the better performing investment option failing in a future iteration of the test.

To mitigate this risk, there should be exemptions to the stitching requirements that allow investment options to roll into better performing products without the need for performance history to be stitched together. An exemption could be so that trustees would not need to indicate the need for products to be stitched when they are flagged by APRA as underperforming and a subsequent transfer is occurring for the benefit of members in the

underperforming option.

RECOMMENDATION 18

Allow for performance history stitching to not occur when underperforming products roll into better performing products as a result of underperformance, to reduce the risk of the performance of the successor being impacted.

We would be more than happy to answer any questions you may have on our submission. Please feel free to contact Aidan Johnson on ajohnson@fsc.org.au.

Yours sincerely,

Spiro Premetis
Executive Director, Strategic Advocacy

Attachment A: Assessment of Benchmarks

Asset class	Current Index	Recommendations
Australian and International Equity	ASA52 S&P/ASX 300 Total Return Index Various MSCI International equity benchmarks.	We recommend Government consider including additional benchmarks to distinguish for Large/Mid/Small/Micro-cap strategies (both Australian and international equities).
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 or TDP context.
Australian Unlisted Infrastructure	MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) - Nav-Weighted Post-Fee Total Return (All Funds)	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

Asset class	Current Index	Recommendations
		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.
International Unlisted Infrastructure	MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) - Nav-Weighted Post-Fee Total Return (All Funds)	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 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

Asset class	Current Index	Recommendations
		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 Income	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 Inflation 10+Yr Index' or failing that the 'Bloomberg Ausbond Inflation 0+Yr Index' for benchmarking exposures to inflation linked bonds.

Asset class	Current Index	Recommendations
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. 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

Asset class	Current Index	Recommendations
		against a benchmark that consists of 50 per cent international equities. 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

Asset class	Current Index	Recommendations
		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. 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.