| HESTA |

An Industry SuperFund

Your Future, Your Super package

Submission to the Australian Government, The Treasury

HESTA welcomes the opportunity to make a short submission on the reform package described as covering:

- Best Financial Interests duty;
- Single Default Account; and
- Underperformance.

We support the policy intent to strengthen Australia's sophisticated retirement system and ensure better outcomes for members. We make this submission to assist the Government in understanding how the proposed changes might be improved to deliver the intent of the policy but do so in a manner that continues to build our internationally acclaimed system.

HESTA holds $56 billion of assets on behalf of 870,000 members in the health and community services sector, 80% of whom are women. The performance of those assets and our members' financial wellbeing can be materially impacted by even small changes to the retirement system. Our members rely on us to ensure that their retirement story is told, and their working life is considered in complex policy deliberations. Our typical member is a 43-year-old female. She works in health or community services where she earns on average 15.9% less than her male counterpart doing the same job with the same skills[1]. She spends considerable time caring for others in an unpaid capacity which adds enormous economic benefit to the country. Because of all this, at 43, she has less than $30,000 in superannuation and will be financially penalised in retirement. The way in which HESTA can operate and invest matters to our members because they participate in a sophisticated system that doesn't yet adequately reflect their working lives.

We welcome any reform that strengthens the system for our members, we make this submission to be read in conjunction with the submissions of our representative bodies and industry partners particularly the Australian Institute of Superannuation Trustees (AIST), Industry Super Australia (ISA) and the Association of Superannuation Funds Australia (ASFA). There will no doubt be tactical differences in submissions from these industry partners – there is no one perfect approach. What is consistent, is the strategic desire and intent to ensure our members receive continued strong returns and can approach and enter retirement confidently.

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[1] https://www.wgea.gov.au/data/wgea-research/australias-gender-equality-scorecard/health-care-and-social-assistance

Best Financial Interests Duty:

Both the Productivity Commission and Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) noted the behaviour of fee setting beyond cost recovery and the profiteering culture as potentially contrary to member's best interests.

Any reforms that attempt to address these important issues should consider the role of dividends and the methodology of fee setting. It is concerning that the exposure draft does not effectively do this. The explanatory memorandum to the draft Bill introduces a concept of different treatment of "core" expenditure and "discretionary" expenditure. This appears to go beyond the scope of the Bill itself, and further, does so in a manner inconsistent with the way expenses were considered by the Productivity Commission and the Royal Commission.

For example, we strongly disagree that expenditure promoting fund awareness in an environment with low literacy and engagement may not meet the best interest test.

Trustees are already obligated to act in the best financial interests of members, as the "best interests' obligation" has been interpreted by the Courts to mean "best financial interests" since Cowan v Scargill (1985). Unlike retail superannuation providers, we do not distribute profit in the form of dividends to a parent company and then enact our trustee obligations over the remainder of the resources.

Noting the Trustees duties already in practice and our ongoing commitment to transparency, we strongly disagree that Treasury should be given the extraordinary powers to draft regulations prohibiting certain payment types. This overreach was never opined by the Royal Commission nor the Productivity Commission.

The benefit of any Trust structure is to allow those who are best positioned to know the interests of members to apply that knowledge. The role of the Regulator – recently appropriately strengthened, is to enforce this. The proposed reform allows the intervention of people without the knowledge and experience of the members into this structure at an abstract level. This undermines the very nature of the trust structure used widely in Australia to align the benefits of members with decision makers and represents a retrograde step in the superannuation landscape.

Single Default Account

HESTA has previously made detailed submissions on the matter of "stapling". We encourage a review of these submissions and those made by our industry partners, particularly ISA, prior to any further consideration of the legislation.

We strongly believe that a better model for ensuring the non-proliferation of multiple accounts should be based on the automatic rollover of balances, whereby a member is "stapled" to their balance which is automatically rolled over into their new account when

they join a new employer. This will require an ongoing role for the Fair Work Commission to ensure funds receiving money are appropriate for their industry.

Many of our members rely on the ancillary products we are obligated to supply – such as life and incapacity insurance. Under the Government's proposed model of "stapling" a new workforce entrant who is stapled to a product while working in a relatively low-risk industry such as retail, but who later moves into a higher-risk industry such as nursing, will retain an insurance policy that is unlikely to cover them appropriately.

We strongly endorse the findings of the KPMG Report commissioned in 2019, found here examining how the use of technology could tackle underperformance and multiple accounts simultaneously.[2]

Underperformance

We support the policy intent to give greater transparency to beneficiaries and protect them from underperforming products.

In order to properly deliver that intent, performance should be assessed on Net Returns. We are not clear about the reasons why the Government would choose to use a metric to determine returns before administration fees have been deducted and note that the possibility of including investment fees has been included in the draft bill. The differences in the fee culture of retails funds and industry funds has been well documented by the Productivity Commission, the Royal Commission and recently by APRA in discussion of the 2020 heat maps[3]. We encourage the Government to consider the recent analysis of the Heatmap by ISA and referenced in their submission to this consultation. If the aim of the reforms is transparency and protection, it is crucial that all fee types be considered so that the end result is reflective of what members will receive in their accounts.

Further, we encourage a more nuanced conversation about systemic underperformance rather than the blunt measures discussed in the budget announcement. It may be that from time to time, strong funds will underperform at the margins of the proposed measure. The proposed measure should consider systematic underperformance which might be evidenced over a longer period of time or a more material difference from the benchmark.

The time period proposed in the budget papers for the assessment is not reflective of contemporary understanding of market cycles. Investment performance should be considered over a longer time period of 10 years.

[2] https://www.industrysuper.com/media/stapling-of-superannuation-accounts-an-independent-analysis-by-kpmg/
[3] Helen Rowell, Speech to ASFA Briefing, APRA Heatmaps 2020

Our concerns about the proposed benchmarks within the performance test as discussed in the budget papers, are similar to those raised by other industry participants and stakeholders, primarily:

- the limited capacity to consider the different risk characteristics of investments and the appropriate management of risk, including use of defensive and growth options, to match members' needs across their lifetimes;
- the incentive this will likely create for trustees to focus on the management of risk and returns relative to the proposed benchmark rather than absolute returns to members; and
- the disincentives this will likely create for investing into real and unlisted assets such as important community infrastructure in Australia; and
- the lack of consideration of different asset allocation strategies, which are an influential driver of returns for members.

We have particular concerns about the proposed treatment of unlisted assets in the benchmarking methodology.

For example, the use of a listed index – the FTSE Core Developed Infrastructure Index hedged to AUD (the "FTSE" index), as proposed in the exposure draft, is simply not an appropriate benchmark for unlisted infrastructure. The impact of this will be covered in detail in the submission made by Industry Funds Management (IFM) and we encourage the Government to consider this in deliberations. To summarise some of the concerns –

1. Listed infrastructure indices display correlation with other listed indices, not with the underlying asset class.
2. The FTSE is largely exposed to North American infrastructure, and primarily across the utilities, railroads and conventional electricity sub-sectors. It includes a number of sectors that many established infrastructure funds do not invest in (e.g. conventional electricity, railroads) and comprises only 4% transport infrastructure, which makes up the largest subsector of both our Australian and global infrastructure funds.

This is one example of the ill-considered approach of using listed benchmarks to assess the performance of unlisted assets.

It will be to the detriment of the nation, and our economic recovery from the pandemic, if proposed benchmarks make unlisted infrastructure unattractive. A significant incentive for HESTA to invest in the unlisted market is that the investment is not correlated to listed markets and will diversify a portfolio away from listed market volatility to provide earnings stability, protection from inflation and portfolio risk management. The same argument can be applied to agriculture, social infrastructure, roads, transport, ports. This issue requires immediate attention.

We note also the limitations of basing the proposed test on a "reference portfolio approach". This is not reflective of contemporary portfolio construction techniques that use a Total Portfolio Approach (TPA). This is widely regarded as the most effective method and has been adopted by the world's leading funds.

TPA refers to the management of risk and return not just through strategic asset allocation but also through asset selection within asset classes. This is a sophisticated approach, widely used in Australia and leading international pension funds, and yet would likely be considered as high-risk relative to the proposed performance test.

HESTA supports the policy intent of the Your Future, Your Super. However, there are significant issues with the proposed design and implementation of the reforms that mean they do not address the fundamental issues raised by the Royal Commission or the Productivity Commission in relation to underperformance and governance. Further consideration should be given to all areas of the package in order to deliver the policy intent.