Industry Super Australia

Melbourne
Casselden Place
Level 39, 2 Lonsdale St,
Melbourne, VIC 3000
P: (03) 9657 4321

Canberra
Dialogue
GF, 4 National Circuit
Barton, ACT 2600
P: (02) 6269 5710

18 December 2020

Manager
Retirement Income Policy Division
Treasury
Langton Cres
Parkes ACT 2600
By email: superannuation@treasury.gov.au

Your Future, Your Super: exposure draft legislation

Industry Super Australia (ISA) undertakes policy research and advocacy on behalf of over five million members of industry superannuation funds, to ensure that the policy settings for superannuation are consistent with the objective of maximizing their retirement incomes.

We welcome the opportunity to comment on the exposure draft legislation published by Treasury in support of the proposed *Your Future, Your Super* (YFYS) policy package.

ISA has broadly welcomed the YFYS package. It contains several measures that have the potential to improve retirement outcomes for millions of superannuation fund members. However, to realize this potential there are some important problems with the current version of the proposals that require further consideration by the Government.

In the attached submission we highlight a number of those problems. In some cases we suggest alternative approaches that we believe would better serve the interests of members.

Summary of our submission

ISA holds the following high-level concerns about the Government's approach to designing and implementing the YFYS package.

Best financial interests

- ISA believes that the best financial interests measures as currently drafted represent a missed opportunity to materially improve the superannuation system for members. It is unduly focused on activity by industry funds that has been proven to be in members' best financial interests, while ignoring billions in dollars of gouging in the retail sector.

- Dividend payments by for profit funds are out of scope of the best-financial interests test. Accordingly, the measures do not focus on the financial arrangements which the Productivity Commission and Hayne Royal commission identified as contrary to members' interests. Based on Productivity Commission analysis of underperformance by the retail sector, we estimate that these dividends are worth $10 billion a year.

- The exposure draft legislation includes an unnecessary and inappropriate regulation power. Regulations can be made to ban payments or expenditure that would otherwise be in the best interests of members and to make specific record-keeping obligations supporting payments a strict liability offense.

- The reverse onus of proof coupled with no materiality threshold places an unreasonable burden and excessive red tape on trustees the cost of which can only be passed onto members. An appropriate regulatory impact assessment of the cost of the measures must be undertaken.

- Unless the regulators provide guidance on how they will administer the best financial interests duty the Explanatory Materials accompanying the legislation will be the primary source of guidance for industry on how the law will be administered. In this case the Explanatory Materials need to be less prescriptive, more balanced, and not stray beyond the law.

Addressing Underperformance in Superannuation

- ISA supports assessing product performance by reference to Net Returns – rather than the Net Investment Return measure being proposed by the Government. A Net Return measure better reflects the actual returns that members receive in their accounts. Net Investment Returns ignores the impact of administration fees, which tend to be higher in the retail sector than among not-for-profit funds. This is also the position taken by the Cooper Review and the Productivity Commission.

- All APRA regulated superannuation products should be subject to annual performance testing by APRA, not just MySuper and so-called 'Trustee-Directed Products'. The Government's proposals ignore pension products and carves out thousands of 'choice' options. This is contrary to the approach recommended by the Productivity Commission, which identified chronic underperformance in many choice products. All members in our compulsory system deserve to know if they are in an underperforming product.

- The proposal to identify underperforming products by reference to a single metric (50 bps below benchmark) fails to distinguish between marginal and chronic underperformance. The proposed consequences for two consecutive years of underperformance (being closed to new members) are the same for all. Government should consider tougher measures for persistent and chronic underperforming products that will better protect the interests of members in such products.

Single Default Account

- Stapling members to products risks members who move from a low-risk industry to a higher-risk industry retaining insurance that may not cover them for death or TPD should a claim have to be made. This problem is solved if members are stapled to their balance which is then automatically rolled into an employer's default product when they start a new job. This version of stapling is the one favoured by ISA.

- The Government's proposal to staple all members to their current product from 1 July 2021 risks members being stapled to, and remaining within, poor performing products.

ISA supports stapling members only to products that have been subject to performance testing and identified as not underperforming.

- There are no proposals to deal with the remaining stock of unintended multiple accounts that are not covered by the Protecting Your Super measures. In 2018 the Productivity Commission estimated that there about 10 million such accounts across all balances, with members' savings being eroded by $2.6 billion each year because of duplicate fees and insurance.

ISA recommendations

ISA seeks the following changes to the YFYS package.

Best financial interests

1. The Best Financial Interest test must include dividend payments and the setting of fees.
2. The classification of expenses and differential standards to be applied depending on that classification in the Explanatory Materials for core and discretionary expenditure should be removed. Trustees should be able to determine for themselves what evidence and supporting systems are needed to support different types of expenditure.
3. The Government should remove the power to make regulations prohibiting or placing conditions on payments. We suggest that APRA's existing directions power in conjunction with the ability to make and enforce prudential standards and guidance is more than sufficient to ensure trustees make payments that are in the best financial interests of members.
4. ISA strongly encourages the Government to not reverse the onus of proof and return the evidentiary burden to the Regulators.
5. The Government should include a materiality threshold for payments and expenditure.
6. Treasury should amend the Explanatory Materials to make them less prescriptive, sector neutral, balanced and not go beyond the proposed law.

Addressing Underperformance in Superannuation

1. The Government should reconsider its stated intention to use Net Investment Return and to use Net Return instead.
2. All APRA regulated superannuation products should be subject to performance benchmarking.
3. The Government should consider introducing more stringent penalties for products that chronically and significantly underperform the proposed benchmarks.
4. The performance testing framework should use longer timeframes to assess performance once data is available

Single Default Account

1. The Government should adopt a model of stapling based on the automatic rollover of balances.

2. Members should only by stapled to those funds that have proven they can deliver for members, by being assessed as not underperforming under the Government's proposed performance framework.

3. The Government should include measures to tackle the full stock of unintended accounts as part of the present package.

We would be happy to discuss this submission with Treasury. I can be contacted on [redacted] or [redacted].

Kind regards

Tom McMahon
Senior Manager Policy and Research.

Industry Super Australia

ISA Submission – Your Future Your Super package

Best financial interest

ISA believes that the best financial interest measures as currently drafted represent a missed opportunity to materially improve the superannuation system for members.

Misdirected focus

The exposure draft legislation is not sector neutral and does not address the setting of fees above cost recovery and payment of profits to related parties which are then reflected in dividends to shareholders. The Productivity Commission estimated that these dividends are worth $10 billion a year[1]. Accordingly, the measures are misdirected and do not focus on the financial arrangements which the Productivity Commission and Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry identified as contrary to members' interests. The Productivity Commission stated that 'because super funds are legally obliged to act in members' best interests, the fees they charge should not exceed cost recovery levels[2]'.

This situation was considered extensively in the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry[3] and was supported by case studies that showed outsourcing arrangements with related parties resulted in members paying high fees and receiving poor returns, e.g., AMP Superannuation Limited and NM Superannuation Limited.

ISA Recommendation: The Best Financial Interest test must include dividend payments and the setting of fees

The Explanatory Materials distinguish between expenditure that is 'core or essential to the operation of a superannuation entity[4]' and expenditure that might be considered 'discretionary or non-essential to the ongoing operation of the superannuation entity[5]'. Provided such core expenditure is 'competitively priced[6]' then the expenditure would

[1] Superannuation: Assessing Efficiency and Competitiveness – Inquiry report (December 2018), found that annually there was 1.7 per cent unexplained under performance in the retail sector. Unexplained underperformance (170 bps) x retail funds under management ($597.7bn) equals $10 bn.
[2] Ibid, p 40
[3] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Report, 2019, p 230
[4] Treasury Laws Amendment (Measures for a Later Sitting) Bill 2020: Best Financial Interests Obligation, Exposure Draft Explanatory Materials, paragraph 1.29
[5] Ibid, paragraph 1.31
[6] Ibid, paragraph 1.30

likely be regarded as being in the best financial interests of members. On the other hand, discretionary expenditure must have a business case supported by technical analysis and quantifiable metrics to reflect expected financial outcomes. Different standards are therefore applied in the implementation of the law depending on the nature of the expenditure.

The Productivity Commission report shows 'core' payments such as investment management expenses – often to related parties among retail funds – are one of the largest components of total expense and account for a greater proportion of poor member returns[7]. Of concern is that Explanatory Materials apply a different and lower standard to these expenses than to discretionary expenditure.

Classification of some payments as non-essential or discretionary is misconceived. For example, financial advice has been demonstrated by the Government's own Retirement Income Review to be essential to achieving good retirement outcomes for members[8]. These observations echo the findings of the Productivity Commission[9]. To suggest that financial advice is a non-essential expenditure ignores its critical role in the retirement income system.

Similarly, in a compulsory superannuation system where employees can exercise choice about which fund to join, expenditure promoting awareness of funds is also essential to the efficient operation of the system. Again, given low levels of financial literacy and engagement with the superannuation system it is illogical that expenditure promoting awareness of a fund is 'unlikely[10]' to satisfy the best financial interests obligation. On what basis should members make this important choice?

ISA Recommendation: The classification of expenses and differential standards to be applied depending on that classification in the Explanatory Materials for core and discretionary expenditure should be removed. Trustees should be able to determine for themselves what evidence and supporting systems are needed to support different types of expenditure.

Regulation making power

The Bill enables the regulations to prohibit payments or investments which would otherwise be in the best financial interest of members. This is an extraordinary intervention in the market and limit on the proper discretionary duties of trustees. We know of no similar approach made elsewhere in corporations, finance or tax law. A legislative structure that allows trustees to lawfully make certain decisions which can be demonstrated to be in the best interests of their members and yet allows regulations to

[7] Superannuation: Assessing Efficiency and Competitiveness – Inquiry report (December 2018), Finding 7.3
[8] Retirement Income Review Final Report, July 2020, p 17
[9] Superannuation: Assessing Efficiency and Competitiveness – Inquiry report (December 2018), Finding 5.4
[10] Treasury Laws Amendment (Measures for a Later Sitting) Bill 2020: Best Financial Interests Obligation, Exposure Draft Explanatory Materials, paragraph 1.32

be made to prohibit those decisions introduces an unacceptable and unnecessary level of policy and legal uncertainty.

Regulation making powers are generally used to provide further detail on, or to ensure compliance with, legislative obligations. The use of regulation to prohibit or place conditions upon payments and investments in this context is not one that is intended to simplify and support existing legislation.

Further, where the development of regulations are not subject to Parliamentary scrutiny or public debate it is unacceptable that ministerial powers can be exercised to ban payments made by trustees notwithstanding that they can be shown to be in the best financial interest of members. Any such prohibition could not be appealed on the basis of compliance with the best financial interest obligation.

ISA Recommendation: The Government should remove the power to make regulations prohibiting or placing conditions on payments. We suggest that APRA's existing directions power in conjunction with the ability to make and enforce prudential standards and guidance is more than sufficient to ensure trustees make payments that are in the best financial interest of members.

Burden of proof

There is no reasonable basis for the highly unusual decision to reverse the evidentiary onus of proof and no case has been made to establish grounds for the reversal. Lack of past success by regulators in achieving regulatory outcomes in this area is not a reason to reverse the onus of proof.

Further, it is unreasonable to reverse the evidentiary onus in circumstances where the specific obligations are unknown as the regulations relating to record-keeping are not yet made and can change over time. The reversal of the evidentiary onus is rare and only occurs in the few circumstances where it is appropriate and proportional, for example, in criminal actions involving terrorism, drugs, child sex offences and proceeds of crime. In each of these cases there is a clear policy rationale for the reversal on the onus. This includes evidence of harm and outlawed actions. The reversal of the evidentiary onus is very rarely used in financial law[11].

ISA Recommendation: ISA strongly encourages the Government to not reverse the onus of proof and return the evidentiary burden to the Regulators.

Materiality

The absence of a materiality threshold means it would appear to be an offence for trustees to make any expenditure without undertaking a robust process, including appropriate record-keeping to meet their obligation to demonstrate that any action will yield a quantifiable financial benefit to members. Without a materiality threshold this is

[11] See Section 963L *Corporations Act 2001*, Section 8 *Taxation Administration Act 1953*

an unreasonable and unworkable obligation which will be prohibitively costly and will ultimately not be in members best financial interests.

Given the Bill's presumption that all expenditure, no matter how insignificant, is not in the best financial interest of members, trustees will be required to install extensive systems and record keeping processes to ensure they are in a position to demonstrate that any expenditure or investment decision was reasonably made in the best financial interest of members.

The absence of a materiality threshold is expected to add tens of millions of dollars to trustee running expenses which in turn will reduce returns to members. The figure used in the Regulatory Impact Statement for industry to comply with the measures of $1.7 million (across the whole industry) is based on opaque metrics and grossly underestimates the cost.

ISA Recommendations: The Government should include a materiality threshold

Guidance on administration of the law

In the absence of guidance from the regulators on how they will administer the best financial interest duty, the Explanatory Materials accompanying the legislation will be the primary source of guidance for industry on how the law will be administered. In this case, we encourage Treasury to amend the Explanatory Materials to make them less prescriptive, sector neutral, balanced and not go beyond the proposed law.

Less prescription

As noted above, in our view trustees should be able to determine for themselves what evidence and supporting systems are needed to support expenditure. Given that trustees bear the evidentiary burden, each trustee should be free to provide whatever evidence it decides is appropriate in relation to each payment to demonstrate that it has discharged the statutory duty.

Sector neutrality/balance

As noted in our comments on the exposure draft legislation, setting of fees and payment of profits to shareholders should be covered in the law. An example should also be included showing how payments of profits to shareholders will be assessed in light of the provisions.

Further, while paragraph 1.43 of the Explanatory Material refers to payments to an entity in which a superannuation fund holds equity, it is silent on the more common situation of payments to associates or associated entities of the fund. This effectively excludes the more common situation where the service providers, directly or indirectly, hold equity in or are associates of the superannuation fund. As noted above, fees associated with investment and administration are one of the largest components of fund level expense.

Fees associated with investment management and administration – particularly those paid to related parties - are one of the largest components of fund level expense for retail funds. We understand that payments by retail funds to related parties is the subject of a current thematic surveillance by APRA, underscoring its importance to member outcomes. Given the potential for conflicts of interest, a rigorous test must be applied to payments to related parties.

Extension beyond the proposed law

As noted above, the exposure draft legislation does not contain a different standard depending on whether expenditure is considered 'core or essential' to the operation of the fund or 'discretionary or non-essential'. However, paragraphs 1.30 and 1.31 of the Explanatory Materials point to different standards depending on the categorisation of the expenditure.

Paragraph 1.42 of the Explanatory Materials states that the trustee should 'have oversight that monies paid are being used by third parties for the intended purpose'. The exposure draft legislation does not require this of trustees nor would it be practical for it to do so where the payment is made to an unrelated third party. Further, if the payment is only being partly used for the intended purpose e.g., investment management, and partly used for another purpose, e.g., to pay profits to shareholders or to support a failing entity within the corporate group, then is the payment prohibited? If so, this should be explicit.

ISA Recommendation: Treasury should amend the Explanatory Materials to make them less prescriptive, sector neutral, balanced and not go beyond the proposed law.

Addressing Underperformance in Superannuation

Performance should be assessed on Net Returns

The Government has stated that it intends APRA will use a Net Investment Return (NIR) metric to assess product performance. ISA strongly supports the use of a Net Return (NR) measure instead.

The critical difference between the NIR and NR measures is that the NIR only deducts investment-related fees, costs and taxes from the resulting return, while the NR deducts all fees, costs and taxes. In particular, the NR deducts administration fees, while the NIR does not. As such, the NR is a more transparent and accurate measure of the rate of return that members will actually receive.

It is not clear why the Government has chosen to use a metric (NIR) that measures returns before administration fees have been deducted. Administration fees are a compulsory price that members must pay to gain access to superannuation products. Moreover, they can vary to a significant degree.

The Productivity Commission found that in 2017 the median administration fee across retail funds was 0.8 per cent, compared with 0.4 per cent across not-for-profit funds. On average, a member of a retail fund with a $50,000 balance would pay a total administration fee of $374 a year, compared to $127 a year by a member of a not-for-profit fund.[12] APRA recently highlighted the significant variance in fees, noting that some members can pay two and a half times higher admin fees than other members[13].

In addition, analysis of APRA MySuper Heatmap data by ISA indicates that use of NIR in place of NR has significant consequences for quantifying the extent of underperformance by reference to the proposed 50 bps benchmark among certain funds. For industry, public sector and corporate funds there is little difference in levels of underperformance measured in per cent of asset terms regardless of whether NIR or NR is used. This reflects the relatively minor role that administration fees play in eroding returns to members among these funds.

However, for the retail sector the picture is quite different. Using NIR, and so excluding the impact of admin fees, 8 per cent of retail assets are in underperforming MySuper products. Using NR, and so including the impact of admin fees, results in underperformance increasing to 31 per cent. This reflects the higher average admin fees charged by many retail funds.

High admin fees can translate into materially lower balances at retirement. Cameo modelling of the impact of admin fees by ISA has found that members on average full-time earnings in those MySuper products with the ten highest rates of admin fees will

[12] ibid, p. 171, p. 174
[13] Helen Rowell, Speech to ASFA Briefing, APRA Heatmaps 2020

on average retire with $158,000 less in their accounts than those who are members of MySuper products with the ten lowest rates.

Moreover, the proposed changes ignore the diversion of member funds by means of payments to related party entities, including above-cost payments made for the provision of administrative services. Such arrangements are common among retail funds. The proposals are therefore not sector neutral and the proposed performance measures do not reflect what members will receive in their accounts.

ISA has long advocated for measuring and comparing product performance on the basis of a NR metric. This view has been supported by previous Government reviews including the Cooper Review and the Productivity Commission[14].

ISA Recommendation: The Government should reconsider its stated intention to use NIR and to use NR instead.

Given the choice of metric will have significant implications for identifying and then removing underperformance from the superannuation system, it is important the measure is subject to parliamentary deliberation and specified in legislation.

All members deserve protection

At present, the Government is proposing that the APRA performance test will apply to all MySuper products but only some Choice products. Choice products that meet the definition of a 'trustee directed product' (TDP) will be tested. While the precise definition of a TDP will be proposed in future regulation, it appears that a TDP will be one where the trustee has control over the design and implementation of the investment strategy. For reasons that are unclear, this will not include single-asset options.

Products that are neither MySuper or TDPs will not be tested. ISA analysis indicates that this means around $881 billion in funds under management and 8.4 million member accounts will not be subject to benchmarking. In addition, there are no proposals to assess pension products. A commitment to test further products at an unspecified time is not sufficient.

Carving-out thousands of Choice and pension options from being tested is inconsistent with the approach recommended by the Productivity Commission. Anticipating arguments from parts of the super industry that where members make active investment choices the trustee should not be held accountable for any subsequent underperformance, the Commission countered 'it is the quality of investment options being *offered* to members…that should be the focus of regulatory attention.'[15] The Commission continued:

---

[14] Super System Review Final Report (2010) Part Two: Recommendation Packages, p. 111
[15] Ibid, p. 491

> 'Funds should therefore be required to benchmark all MySuper products and virtually all choice investment options. This should include pre-mixed options, single-class options and options delivered through a member-directed investment platform…Retirement products should also be included…'[16]

While the Commission envisaged that funds should be required to undertake the benchmarking, using a prescribed methodology based on that developed by the Commission's inquiry, there is no reason why APRA could not undertake this work.

ISA Recommendation: All APRA regulated superannuation products should be subject to performance benchmarking.

Consequences should be proportionate

The Government is proposing that MySuper products that underperform their benchmarks by at least 50 bps in one year will be required to notify members. If that underperformance persists for a second consecutive year, the product will be closed to new members. ISA supports timely and effective action by APRA to protect the interests of members in underperforming products.

However, identifying underperformance by reference to one metric (at least 50 bps per below benchmark) does not distinguish between marginal and chronic underperformance.

It is likely that some products will underperform at the margins of the proposed measure, while others will be assessed to have substantially underperformed for some time. The resulting consequences for trustees should be proportionate to the extent and persistence of underperformance. For example, there may be a case for closing a product to new members after one assessment by APRA, if it is found to have underperformed by 150 bps for a significant period.

We encourage the Government to consider how the proposed measures should differentiate between degrees of underperformance, and how consequences should vary to better protect affected members.

ISA is further concerned that products closed to new members may become a new source of legacy product in the system. It is not clear from the proposed package what will be done to ensure members of closed products that do not improve are connected to good products in a timely manner that protects them from being gouged for fees and insurance premiums.

---

[16] Ibid, p. 492

ISA Recommendation: The Government should consider introducing more stringent penalties for products that chronically and significantly underperform the proposed benchmarks

Assessing performance

The YFYS budget paper states that for the purposes of the new APRA test products will be assessed over a seven-year period in 2021, and then eight-year periods from 2022.

In general, products should be assessed over the longest time period possible to account for risk and market cycles. As the new annual APRA test continues to be applied over time, the assessment period should be automatically extended beyond eight-years to a more suitable longer-term timeframe.

However, in the context of the current proposed seven and eight-year periods, it is unclear how products with shorter histories will be treated and assessed. We would welcome clarification of what the Government intends.

ISA Recommendation: The performance testing framework should use longer timeframes to assess performance once data is available

Single Default Account

A better model of stapling

ISA has previously detailed our preferred model of stapling to the Retirement Income Review,[17] based on the automatic rollover of balances.

In this model each member is stapled to their balance which is automatically rolled over into their new account when they join a new employer. Only those products that have been periodically approved by an expert panel within the Fair Work Commission are permitted to be used for default purposes in awards or enterprise agreements.

This is particularly important for those members in high-risk industries, such as construction, transport and the emergency services. Under the Government's proposed model of stapling a member 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 construction, will retain an insurance policy that is unlikely to cover them for death or TPD should a claim need to be made.

ISA Recommendation: The Government should adopt a model of stapling based on the automatic rollover of balances.

Problems of member disengagement

The Government's proposed stapling framework means that from 1 July 2021 members will be stapled to a product regardless of performance. It will initially be a matter for members to resolve the problem of being stapled to a poor MySuper or Choice product. While we advocate for a model based on the automatic rollover of balances, should the Government proceed with its current model, members must not be stapled to poor performing products.

However, we know from the findings of the Productivity Commission inquiry into superannuation that many members of MySuper and Choice products are disengaged from their super and struggle to understand basic financial terminology.

The risk that many members will be stapled to poor products and remain there for too long with harmful financial consequences, is considerable. Cameo modelling by the Productivity Commission estimated that a member receiving the median bottom quartile fund return over the course of their working life would retire with $660,000 less than a member who received the median top quartile return.[18]

---

[17] ISA (2020) Submission 1: Cohesion – Underperformance and Protecting Members, p. 2, available at: https://www.industrysuper.com/assets/RIR-Submissions-and-Attachments/Retirement-Income-Review-Submission-1-Cohesion.pdf?vid=3
[18] Ibid, p. 11

To better protect members from the risks that will result from stapling all members to their current product on 1 July 2021, ISA believes that stapling to any product should take place only if the product has been tested by APRA and found to have not underperformed.

ISA Recommendation: Members should only by stapled to those funds that have proven they can deliver for members, by being assessed as not underperforming under the Government's proposed performance framework.

Multiple accounts

While the Government intends that stapling members to their product will prevent the creation of new unintended multiple accounts going forward from 1 July 2021, there are no proposals to deal with the existing stock of multiple accounts. The Productivity Commission estimated that there were about 10 million such accounts in 2018, eroding balances by $2.6 billion a year in unnecessary fees and insurance.[19]

Some low balance inactive accounts will be dealt with under the Protecting Your Super measures. However, many will remain. The Commission recommended increasing the balance threshold for auto-consolidation over time (Recommendation 5). The Government has yet to accept this recommendation, or to make alternative proposals.

ISA Recommendation: The Government should include measures to tackle the full stock of unintended accounts as part of the present package.

A stapled fund should be defined in legislation

At present the Government is proposing that a fund is a stapled fund for an employee if requirements prescribed in forthcoming regulations are met. The Explanatory Materials states it is anticipated that the basic requirements that must be met for a fund to be a stapled fund may include that the fund is an existing fund of the employee and is able to accept contributions (EM, para 1.21).

In short, there does not appear to be an intention to include a performance requirement.

The question of what fund can qualify to be a stapled fund for an employee has important implications for members and should be subject to parliamentary deliberation prior to being adopted. This is not merely a detail of policy implementation – it is a critical aspect of policy design. It follows that the definition of a stapled fund should be made in legislation, not regulation.

[19] Ibid, p. 2