25 May 2021

Director
Retirement Income Policy Division
The Treasury
Langton Cres
PARKES ACT 2600

Email: superannuation@treasury.gov.au

Dear Sir/Madam

Consultation: Your Future, Your Super Regulations

The Actuaries Institute (the "Institute") welcomes the opportunity to comment on the Your Future, Your Super (YFYS) draft Regulations. The Institute is the sole professional body for actuaries in Australia. Our members have had significant involvement in the development and management of superannuation within Australia, not only on defined benefit matters where there are prescribed actuarial roles, but also on regulation, financial reporting, insurance in superannuation and risk management.

The Institute supports the intent of the Regulations.

We welcome the changes which have been made from those initially outlined when the YFYS legislation was proposed, and are pleased that the draft Regulations confirm that assets underpinning defined benefit liabilities are not subject to the Performance Test.

However, we have major concerns regarding aspects of the draft YFYS Regulations.

In particular the proposed Performance Test is not sound for its intended purpose and may in some cases be to the substantial long-term detriment of members.

We recommend that either:

- **the introduction of the Performance Test is deferred until the major concerns we have identified are addressed; or**
- **if the Test is legislated, the requirement for funds to take action based on the Test should be subject to a transitional period while these issues are reviewed and resolved.**

We would be pleased to consult further on the design of the Performance Test.

We are also concerned that the YFYS Regulations as drafted may lead to many members inadvertently losing valuable insurance in superannuation benefits.

Overall comments

We believe the Annual Performance Test assessments set out in the draft Regulations are not sound for their intended purpose.

The Performance Test:

- Fails a pub test, as products with top quartile net returns can fail the Performance Test;
- Focuses on implementation of strategy not outcomes, meaning products with an almost identical risk profile and net returns can have very different Performance Test results;
- Does not consider risk;
- Does not allow superannuation trustees to appropriately manage the risk of failure given the Test's retrospective nature;
- Will likely act to reduce fund returns as trustees manage the risk of failing the Test;
- Relies on information which is not yet collated by APRA for trustee-directed products and also historical information which can potentially be inaccurate; and
- May lead to large movements of superannuation fund assets in the short term, potentially causing liquidity issues, lowering returns for members of impacted funds.

Further, the ramifications of failing the Performance Test need to be proportional to its reliability. There are significant consequences for a product and its members that fails, including sudden large outflows that create liquidity issues and adverse member outcomes, particularly to the disadvantage of remaining members, yet the Test is applied in a blunt manner.

We are also concerned that the basic nature of the YourSuper comparison tool in the draft Regulations will potentially lead to inappropriate consumer choices and, coupled with the YFYS stapling proposals, may lead to many members inadvertently losing valuable insurance in superannuation benefits. This is of particular concern for members entering dangerous occupations.

The Institute's specific comments on these matters are set out in the Attachment to this submission.

We would be pleased to discuss this submission or to provide further information. Please contact the CEO of the Actuaries Institute, Elayne Grace at elayne.grace@actuaries.asn.au, if you wish to clarify any aspects of this submission.

Yours sincerely

Jefferson Gibbs
President

Attachment

Detailed feedback on Annual Performance Test and YourSuper comparison tool

Annual Performance Test

The Institute has several concerns the Annual Performance Test set out in the draft Regulations does not distinguish poorly performing products, and may in the long term be detrimental to members' best interests.

1. Narrow focus on only measuring execution of an investment strategy, not the member outcome

   The proposed Annual Performance Test focuses on the execution of an investment strategy, not on the appropriateness of the investment strategy itself. For example, a MySuper product with top quartile returns can fail the Performance Test. Conversely, a product which was wholly invested in cash would likely pass the Test (assuming administration fees are not excessive), however for many members this would not produce a good member outcome given the long period to retirement and beyond. Both examples indicate the Performance Test is poorly designed as a mechanism for protecting members from poor investment outcomes.

   We appreciate that the original Test design was proposed as part of the Productivity Commission review into superannuation. While some concerns were raised at the time, given the Productivity Commission was conducting reviews at a sector or fund level, this approach had some merit. In a letter response to MTAA on 13 November 2018, the Productivity Commission noted (emphasis added):

   > *Our investment performance assessment (as referenced above in our draft Inquiry report and supplementary paper) informs our* ***system-level assessment*** *of the competitiveness and efficiency of the superannuation system.*

   To then use the same approach to justify closing a specific MySuper or trustee-directed product is not appropriate. As per other industry feedback, and consistent with the Productivity Commission's research, "*asset allocation is the largest driver of total net returns*". To disregard asset allocation's contribution to a member financial outcome and only focus on the implementation of the asset allocation provides a very narrow focus.

   Examples

   We provide below some conflicting results from the latest APRA Heatmap, which uses similar methodology to the proposed Performance Test.

   Example 1: Comparable net investment return, significantly different test results

MySuper Product	Strategic Growth Allocation	6 year net investment return	NIR relative to Listed SAA benchmark portfolio
CBA Group – Accumulate Plus Balanced	62%	5.57%	-0.98%
Aon MySuper55	63%	5.57%	0.07%

Source: APRA Heatmap as at 30 June 2020, released Dec 2020

These are two MySuper products shown with the same strategic growth allocation and the same 6-year net investment return. However, one product was calculated as significantly underperforming to the listed Strategic Asset Allocation (SAA) benchmark while the other outperformed. **It is not appropriate to use a test design where two similar products can have the same member outcome but one product fails the Test, particularly given the significant implications to a fund in the event of a failure.**

Example 2: Different net investment return, same test result

MySuper Product	Strategic Growth Allocation	6 year net investment return	NIR relative to Listed SAA benchmark portfolio
Local Government Super – Lifecycle Conservative	31%	4.30%	-1.23%
BT Super – MySuper 1940s	28%	3.43%	-1.23%

Source: APRA Heatmap as at 30 June 2020, released Dec 2020

These are two MySuper lifecycle products with similar strategic growth allocations and similar Listed SAA benchmark results. However, LGSuper outperformed BT Super by 0.9% p.a. over the 6 years. Given the significantly better member outcomes to LGSuper members compared to BT Super, it is concerning for the Test to show the same result.

We recognise that the Performance Test in the regulations will be different to the APRA Heatmap Listed SAA, particularly given the new unlisted benchmarks and the inclusion of administration fees (compared to the relevant product group's median). Also, lifecycle products will not be considered at the option level, but at the combined MySuper product level (weighted by FUM). We also expect that some of the discrepancies above are caused by historic data issues, which must be clarified by APRA in consultation with affected funds before being used for the legislated Performance Test.

However, as real-world examples, these demonstrate the weakness in focussing only on the implementation of an asset allocation. **The Test's narrow focus on implementation is not measuring the member's actual financial outcome.**

2. <u>Retrospectivity</u>

The consequence of failing the Performance Test is significant. Applying the Test using net returns from 1 July 2014 relative to the product's SAA can disadvantage those trustees who sought to manage potential market risks (to increase likelihood of delivering to their CPI based objectives as set out in the product PDS) by deviating from their SAA. This is inappropriate, given the trustee was likely acting in the best financial interest of product members at the time. Changing the goalposts retrospectively is unfair, especially when the outworking will damage the reputation of the superannuation industry as a whole, as the measure of a "dud fund" in the Performance Test is not one on which superannuation funds have traditionally focussed.

Given the retrospective nature, we recommend there is some softening of the consequences of failing the Test for a transitional period, subject to oversight from APRA.

3. Misalignment with the YourSuper comparison tool

Whilst the Annual Performance Test looks at performance against benchmarks, the YourSuper comparison tool would appear to look at actual net returns. As demonstrated in Example 1 above, it is quite possible that investment products may underperform relative to the Annual Performance Test yet exhibit strong relative performance on a net returns basis (i.e. be high ranking on the YourSuper comparison tool). This will be confusing and in some cases misleading, for members and illustrates the disconnect between the Performance Test and the YourSuper comparison tool.

4. No inclusion of risk measures

Risk is an important consideration and is embedded in all areas of superannuation legislation, regulation and policy design. However, despite suggestions following release of the Explanatory Memorandum on the YFYS Bill, the proposed Annual Performance Test does not incorporate any risk measures. Overlaying risk is an important part of a trustee's investment strategy for MySuper and trustee-directed products. Similar concerns have been expressed by other industry bodies, such as the Conexus Institute research, and alternative suggestions put forward to accommodate risk in the Test[1].

5. Inherent constraints to Trustee's management of investment products in members' best interests

Whilst a trustee will still wish to manage investments to promote members' best financial interests, to do so it must pass the Performance Test. This will place trustees in a difficult situation. The Test constrains investment strategy relative to the SAA (i.e. the trustee must always be mindful of tracking error against the SAA benchmark return) to the potential detriment of members. Given the design of the Test, in aggregate the expectation is that portfolios designed to pass the Test may have lower expected returns, be less effectively diversified, and bear more risks in terms of volatility than portfolios constructed in the absence of the Test. For example, in order to increase the probability of passing the Test, trustees will be more reluctant to invest in ESG investments even when these may produce better longer-term outcomes.

6. Ability to actively manage benchmarks used in Test prospectively

The Performance Test is based on performance relative to the product's SAA. Given most products can deviate tactically from their SAA (i.e. set a Tactical Asset Allocation (TAA)), there is opportunity to game the benchmark by setting a SAA that is weighted to assets with lower expected benchmark returns, and then investing tactically with a TAA weighted to assets with expected higher returns. This indicates a fundamental flaw in the proposed Test that encourages "active management" by funds. Consequently, while the initial Test result is expected to result in some products failing, due to its retrospective application, it is

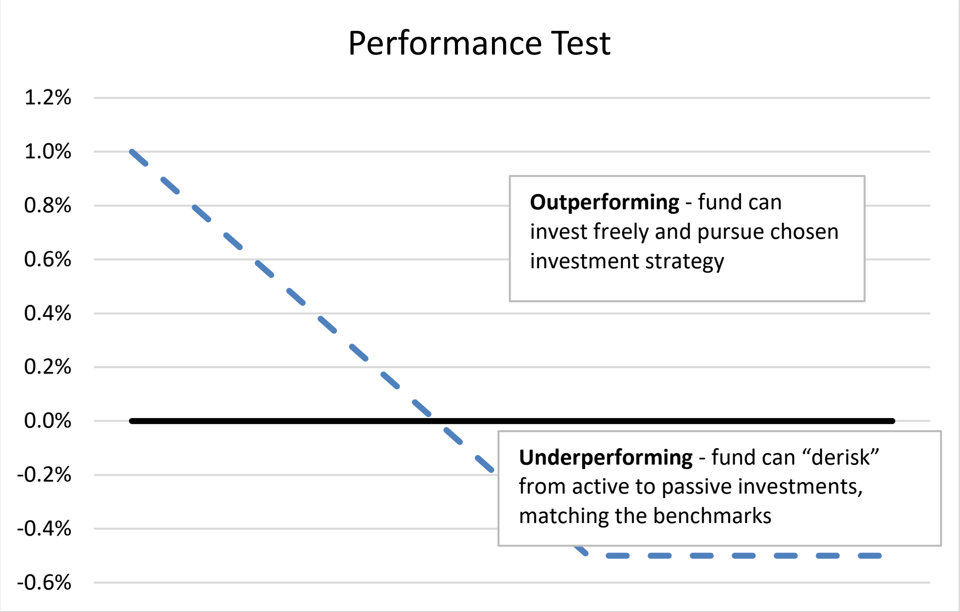
[1] https://theconexusinstitute.org.au/resources/your-future-your-super/

possible that future Tests will have few failures. This could be addressed by basing the Test on actual asset allocation.

7. Move to passive investments and match benchmarks

By moving underlying investments to passive managers and matching the regulated benchmarks, a fund can guarantee that its Test results will not worsen and as a result avoid "failure". The fund will effectively "de-risk" against the impacts of the Performance Test as it approaches the threshold. This is possible because the Test narrowly focusses only on the implementation of an investment strategy and disregards the impact of asset allocation.

Consequently, while the Test will pick up underperformers initially due to its retrospective application, in future years funds will be able to adjust their investment managers as they approach the underperformance threshold to ensure they do not fail an annual Test. The chart below illustrates likely behaviour by a fund as it looks to avoid "failure".



If trustees behave this way, the Test will offer minimal value going forward as underperforming funds will instead cluster close to the threshold.

The risk of failing the Test significantly outweighs any benefits of a trustee showing conviction in their investment approach. Rather than trying to actively manage their investment strategy, due to the strong penalties involved in failing, funds may decide that they need to manage to the prescribed benchmarks. This constraint on investment strategy is not the result of the general concept of introducing benchmarks which the Institute supports; it is the result of introducing a narrow Test that comes with significant penalties for breaching an arbitrary threshold. We recommend that the Test be expanded to include a risk component.

8. Historic data issues affecting validity

APRA has been undertaking its superannuation data transformation project, looking to uplift the quality and depth of superannuation data. APRA has publicly acknowledged that it needs to significantly enhance the comparability and consistency of reported data.[2] Data quality has been improving, but there remain questions over historically reported data, particularly older periods, for reported strategic asset allocation, administration fees and for the depth of information reported for trustee-directed products. Chant West has publicly released its submission to the YFYS Regulations, which confirms the potentially significant impact of historic data quality on the Test's validity.

The consequences of failing the Performance Test are severe, and there are consequences for the integrity of the Test because of these historic data issues. These could be mitigated by deferring application of the Test until these historic data issues are addressed. We also support using latest administration fees in the Test (where the data is more comparable) as opposed to those over the past 7 or 8 years. This has an additional advantage as the latest administration fees provide a more accurate predictor of future fees going forward.

9. Treatment of administration fees

The Institute understands and supports the logic of including administration fees in the Performance Test. However, the methodology proposed creates issues given different members in the same product may be charged different administration fees (e.g. employer scale discounts), and in some instances employers meet part or all of their employees' fees on their behalf. Whilst using the headline PDS rate is reasonable for APRA Heatmaps, which guide the APRA supervisory teams as they focus on member outcomes, failing to account for discounted or subsidised fees in the Performance Test may lead to cohorts of members being advised they are in an underperforming product when this is not the case for them.

The Regulations should include specific exclusions or adjustments for cohorts of members who are charged different administration fees.

10. No inclusion of insurance

With the inclusion of administration fees, the Performance Test functions more like a general consumer product test, rather than a strict investment performance test. However, it does not consider the level or cost of insurance cover.

Insurance in superannuation is an important product feature. Whilst we understand the difficulty in including insurance, given the many variables, we believe that this is a reason why a product failing the Performance Test may not necessarily be an inappropriate product for the member concerned. Indeed, a member may have the cost of their insurance met by their employer, but only if they remain in the product.

[2] APRA https://www.apra.gov.au/consultation-on-apras-superannuation-data-transformation

Insurance should therefore be recognised when assessing whether a failure to meet the Performance Test means the fund is not promoting members' financial interests (as per the SIS Act section 52 Annual Outcomes Assessment amendment).

11. Definition of product

    The Regulations refer to trustee-directed products. In the SIS Act and SPS 515 member outcomes framework, and also the Design and Distribution Obligations, these would be considered investment options, not products. This is very confusing.

    Further, the Explanatory Memorandum to the YFYS Bill states: "Trustees must take into account the results of the Performance Test when completing their annual outcomes assessment. Trustees of a product that fails the Performance Test will find it very difficult to show that the product is promoting the financial interests of beneficiaries in their annual outcomes assessment". The likelihood is that a trustee will remove a trustee-directed investment option product that fails the Performance Test from its Choice product menu, but the Choice product itself will continue to promote the financial interests of its members. The Explanatory Memorandum should be amended.

12. Outworking will lead to significant asset flows in the short term to member and industry detriment

    Failing the Performance Test in year one requires the trustee to inform affected members of this and suggest that they consider moving their money into a different fund. Given the retrospective nature of the Test, the number of MySuper products that will fail the Test in year one is material. Senator Hume has indicated that Treasury estimates 25 products might fail the Test as at 30 June 2021, potentially impacting over 3 million superannuation fund members with over $150b in MySuper assets. It follows that there is an expectation that a substantial transfer of assets will occur within a very short period following issue of the member notice. The likelihood is that this will impact on liquidity of affected products, trigger capital gains tax on redeemed assets, and potentially reduce returns for those members who do not act on the notice but remain in the product. APRA should be asked to provide counsel and advice, as this threatens to undermine confidence in the superannuation system.

Wording of information in notice under subsection 60E(2)

The Institute has several concerns with the wording as set out in the subsection 60E(2) notice which we believe is inappropriate, potentially misleading and should be reviewed.

1. The notice states "*The annual performance assessment compares the earnings of your product (after your super fund deducts fees) against similar funds…*". This statement is wrong – it does not compare performance against other funds, as it compares the execution of the fund's investment strategy against its own targets. We are very concerned about its inclusion as it indicates a fundamental lack of understanding of the Performance Test as prescribed in the Regulations.

2. The notice starts by saying "*Your superannuation product has performed poorly*". For the reasons set out above, failing the Performance Test does not mean that the product has performed poorly relative to other criteria. This statement should be removed.

3. The notice says in relation to members who are in a product that fails the Test "*You should consider moving your money into a different fund*". Many members hold interests in MySuper products and one or more investment options in their fund's Choice Product. Just because a product they hold fails the Performance Test does not mean they should move all their money to a different fund. The notice should instead refer to considering moving money in the affected product to a different product.

4. The statement on switching refers the member to the YourSuper comparison tool. A superannuation product can fail the Performance Test yet still rank well in the YourSuper comparison tool.

5. There is no mention of insurance cover, and the risks of losing valuable cover if the member switches their superannuation particularly for members in dangerous occupations. This is opening up the superannuation system to consumer complaints and litigation. There must be a separate section on the notice covering insurance.

6. While the notice includes comments on past performance not necessarily being a reliable indication of future performance, and also about risk, these should also be referenced in the "*What can I do now?*" section.

7. The notice as drafted is providing personal financial advice, as it is advising the member to consider moving their money. However, the advice is not based on a full assessment of the member's personal situation, nor is this necessarily the appropriate advice in all circumstances (e.g. the product has performed well against its peers, but not against its own benchmarks, or the member does not pay the administration fees used for the assessment). We query whether the Corporations Act would allow the trustee to issue this notice as it stands.

YourSuper Comparison Tool

The Actuaries Institute has concerns that the simplistic nature of the YourSuper comparison tool potentially undermines many significant safeguards recently introduced to better protect superannuation fund members, such as SPS 515 – Strategic Planning and Member Outcomes, and the Design and Distribution Obligations.

1. Consumers using the YourSuper comparison tool with the basic information presented are not protected from making inappropriate decisions, as the net returns listed are not risk adjusted, and there is a danger members will select inappropriate products for their circumstances.

2. In SPS 515, APRA requires trustees to segment their business and members into appropriate cohorts. It recognises members are different and products and offerings that are suitable

for one cohort of members might not be suitable for a different cohort. In DDO[3], trustees are encouraged to make target market determinations, which look at the suitability of certain investment options. These are important safeguards and should be reflected consistently in the YourSuper comparison tool.

Recommendations

We make the following key recommendations in relation to the YourSuper comparison tool:

1. Cohort analysis

   - At least three different levels of member age and account balance should be shown as they are the two key variables to consider in disclosing fees, and investment risk and returns. This requires collecting relevant data and information from funds applicable to nine (three times three) member segments.

   - When members click into the comparison tool site, they should select their age and whether they are a new worker or existing member. Based on the information entered, the comparison tool could only disclose the information that is relevant to the members based on the identified segment the member belongs to.

2. Time periods

   - Investment returns should be presented over a long time period and also broken down into separate periods (e.g. 12 years broken down into three separate and independent four year periods).

3. View funds ranked by Net Return or Fees

   - The draft Regulations envisage presenting funds ranked by either Net Return or Fees. It is unclear whether these two rankings are to be presented side by side or sequentially or, indeed, whether they will be presented based on the user's selection from a drop-down box. Given that Net Return encapsulates the impact of fees, we suggest that the Net Returns ranking should be the default presentation.

4. Insurance cover

   - We appreciate the complexity involved in insurance arrangements. However, while insurance information might be difficult to disclose in a way that is both informative and simple for members and comparable across different providers, we believe it should not be a reason to stay silent about insurance. This is particularly important as some members in specific high-risk occupation categories might not realise they have limited insurance cover if they are members of certain funds.

   - Accordingly, there needs to be prominent mention of insurance cover in the YourSuper comparison tool. Indeed, the comparison tool would be an ideal opportunity to raise awareness about insurance within superannuation. Members need to understand the implication on their insurance arrangement before choosing a fund or moving funds. This is of such critical importance we believe it should be included in the Regulations as a YourSuper comparison tool requirement.

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[3] The Design and Distribution Obligations set out in Part 7.8A of the Corporations Act and ASIC Regulatory Guide RG 274.

For example, a prompt to show members a message such as the following might be a good starting point:

"***Do you know about your insurance arrangements with this MySuper product? We recommend you contact the fund on xxx-xxx to understand your insurance cover and premium before making a decision***".

5. Dangerous Occupations

- The stapled fund regime undermines the intent to the Dangerous Occupations Exemption under Section 68AAF of the SIS Act, as demonstrated by the following examples.

    - A 17 year old gets their first job as a retail sales assistant while they are studying at school. As a result they join the default fund, a retail industry superannuation fund. When they are 18, they become an apprentice paramedic. Currently, unless they exercise Choice of Funds, they would join the default fund for the Ambulance Service in the State where they live which is likely to have elected to treat the role of a paramedic as a Dangerous Occupation, giving immediate insurance cover on joining. Under the stapled fund regime as it is currently designed, this person would remain in their original fund where they would receive no automatic insurance until they reach age 25 and have at least $6,000 in their account. Even then, they may be ineligible for insurance due to their occupation.

    - Similarly, a 17 year old commences an apprenticeship as an electrician, which is considered a dangerous occupation.

    - A person moves into a dangerous occupation when they accept a new job but their stapled fund provides poor cover for the nature of the additional risks they now face. Currently their cover would cease under their old fund after 16 months and the new fund would provide cover appropriate to their new job from the date of commencement of their new job. For example, an engineer working from a city office accepts a job offer with a mining company.

- Given the particular value of life insurance and the lack of availability of alternative cover for Australians working in dangerous occupations, which was one of the reasons for Section 68AAF, this unintended consequence of the stapled fund regime should be addressed.

  In order to partially alleviate the adverse impact of the stapling regime for those entering dangerous occupations, it is recommended that the YourSuper Tool (or equivalent Clearing House tool) include the facility for a message to be placed against the employer's default fund highlighting any occupations for which that fund provides immediate insurance cover under the Dangerous Occupations Exemption. The regulations could constrain such messages to ensure that they are not used, for example, for broader marketing purposes.

Further details on our recommendations for the Comparison Website were provided in our December 2020 submission on the draft YFYS legislation.