FUTURE SUPER

25 May 2021
Mr Ben Dolman
Assistant Secretary
Member Outcomes & Governance Branch
The Treasury
Via email (superannuation@treasury.gov.au)

Dear Mr Dolman,

Your Future, Your Super Regulations and associated measures - submission on consultation package

About Future Super

Future Superannuation Group (FSG) is an asset management company specialising in ethical investing. FSG manages the Future Super Fund, a fast growing super fund that has more than $1bn in assets on behalf of over 35,000 members. The RSE licensee of the Future Super Fund is Diversa Trustees.

Further to our submission of 24 December 2020 on the initial consultation package of the Your Future, Your Super (YFYS) reforms, and our meeting with you and your team on 21 May 2021, we are pleased to make this submission on the draft regulations.

Implications of failing the performance test

We support the actions proposed to be mandated in response to when Part 6A products of the *Superannuation Industry (Supervision) Act 1993* (the SIS Act) fail a performance test. We believe it is highly likely that in these cases some form of resolution will need to take place in order to ensure that members' interests are being served by the trustee. Further, it is also highly likely that the Australian Prudential Regulation Authority (APRA) will require impacted RSE licensees to undertake documented actions to address the underperformance, similar to how it responded to the most recent round of heatmap outcomes. In both cases, trustees will mostly likely need to effect some type of product resolution.

There are three forms of resolution that would be implemented in practice:

1. a successor fund transfer; or
2. an internal migration of members to another product; or
3. restructuring the existing product without migrating members.

Each approach is capable of achieving good results for beneficiaries. However, the draft YFYS legislation is not neutral between the three approaches, as explained in the following table:

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Method of resolution	Explanation	Can this be used to resolve a Choice Product?	Can this be used to resolve a MySuper product?
1 - Successor Fund Transfer (SFT)	A SFT under the SIS Regulations (transferring members to an appropriate product in another superannuation fund) subject to the trustee being satisfied that this is consistent with general trustee duties and the SIS Act covenants (e.g. best interests).	Yes. In appropriate circumstances APRA would have the power to determine that the product in the successor fund should be treated as the original Part 6A product for the purposes of the lookback test (see s 60G and proposed regulations 9AB.4 and 9AB.5). However, APRA is not obliged to make such a determination. Therefore, the default position (i.e. if APRA does not make a determination) is that the successor fund product will be treated as a different or new product for the purposes of Part 6A.	Yes (see s 29TC(1)(h) of the SIS Act and SIS Regulation 6.29(1)(c)). In appropriate circumstances APRA would have the power to determine that the product in the successor fund should be treated as the original Part 6A product for the purposes of the lookback test (see s 60G and proposed regulations 9AB.4 and 9AB.5). However, APRA is not obliged to make such a determination. Therefore, the default position is that the successor fund product will be treated as a different or new product for the purposes of Part 6A.
2 - Internal transfer	Terminating the Part 6A product and migrating members within the fund to another product (which may be a new product).	Yes. In appropriate circumstances APRA would have the power to determine that the product members move to should be treated as the original Part 6A product for the purposes of the lookback test (see s 60G and proposed regulations 9AB.4 and 9AB.5). However, APRA is not obliged to make such a determination. Therefore, the default position (i.e. if APRA does not make a determination) is that the product the members are moved to will be treated as a different or new product for the purposes of Part 6A.	No, it is generally not possible to migrate members from one product to another unless all members consent (see s 29TC(1)(g) of the SIS Act). In this respect the options for resolving a MySuper product are more limited than the options for resolving a Choice product.
3 - Restructuring the original product	Restructuring the product 'in situ': amending the governing rules and investment policies applying to the product to increase net returns, without explicitly terminating the product.	Yes. However, there will be a question on whether (a) the restructured product is a different or new Part 6A product for the purposes of the lookback test (which forms part of the performance measure - see draft regulation 9AB.9(3); and (b) if it is not a different or new product, the restructuring may be ineffective to reopen the product immediately absent appropriate amendments to the draft YFYS legislation. There is no clear legal test for when changes to a product will result in it being a different or new product for Part 6A purposes.	Yes. However, (as with Choice products) there will be a question on whether (a) the restructured product is a a different or new Part 6A product for the purposes of the lookback test; and (b) if it is not a different or new product, the restructuring may be ineffective to reopen the product immediately absent appropriate amendments to the draft YFYS legislation. Again, there will always be uncertainty as to whether changes to a product result in it becoming a different or new product or not so there will be uncertainty as to whether restructuring the MySuper product in situ will result in it becoming a different or new product for Part 6A purposes.

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In short, the options for resolving a MySuper product may be limited to a SFT given the uncertainty as to the result where a product is restructured in situ to resolve the problems. However, a SFT will not always be in the best interest of beneficiaries due to the cost of such action. There may well be circumstances where it will be in the best interest of members to restructure the existing product to lower fees and/or increase net returns via a materially altered investment strategy.

As noted in the table, legal uncertainty exists in part because the concept of a 'product' (that is, a class of beneficial interest in a fund) is difficult to pin down. A superannuation product does not have legal personality or continuity of identity in the same way as an individual or corporation. It is a bundle of rights and obligations (which may change), branding (which may also change) and a fluctuating population of members.

It is strongly arguable that where a standard MySuper product within a superannuation fund is restructured so that it becomes a more complex lifecycle MySuper product with multiple stages, it will become a new Part 6A product (although not necessarily a new product for the purposes of Part 2C of the SIS Act). APRA appears to have assumed this to be the case for the purposes of heatmap reporting in relation to the Maritime MySuper Investment Option and the Russell Investments Master Trust Goal Tracker product (see APRA *Insights: MySuper Product Heatmap - Fees and costs update and other observations* (June 2020) p 23).

However, under Part 6A of the SIS Act, that result is not beyond doubt, and it will be quite difficult for APRA to determine in confidence whether as a matter of law such changes have resulted in a different or new Part 6A product. The position may be even less clear in relation to other kinds of changes such as changes to investment policy and fee structure.

Ultimately, the question of whether a product has become a new product due to extensive changes will be one of judgement, and that judgement ought to be made on the individual facts having regard to the purposes of Part 6A. For these reasons we believe that the legislation should give APRA a discretion, to be exercised only in appropriate circumstances, to treat a materially restructured product as a new product for the purposes of Part 6A.

This outcome would promote regulatory neutrality between methods of resolution of a product and would allow trustees to choose a method of resolution that is in the best interests of members. Again, the draft legislation does not prevent a trustee of a choice product from migrating members to another choice product (or successor fund transferring choice or MySuper members to a product in another fund), and it does not compel APRA to deem that the different or new product be treated as the old product for Part 6A purposes. APRA has a discretion, and that is appropriate.

Our view is that the same position should apply to in situ restructures to achieve neutrality between resolution outcomes. If appropriately drafted, this would not result in an erosion of the YFYS measures or the creation of a new loophole as APRA would remain the 'back stop'. If APRA did not act then the default position would either be that as a matter of law the restructure has *not* resulted in a different or new product for Part 6A purposes or that the position is uncertain. In other words, under our proposal, a positive act would be required by APRA to confirm that the product be treated as a new product. This would give APRA the ability to administer the YFYS measures in the manner intended by Treasury - that is, through appropriate exercise of regulatory discretion.

Recommendation

It is recommended that s 60G of the SIS Act be complemented with a new provision which enables APRA to determine (or confirm) that a product that has been substantially restructured in situ should be treated as a new product for Part 6A purposes. Again, APRA, and only APRA, would hold this discretion. We believe the simplest way this could be achieved is by:

- inserting a new provision in the Treasury Laws Amendment (Your Future, Your Super) Bill 2021 (say a new s 60GA) which provides that in circumstances of a kind specified in the regulations, for the purpose of provisions of Part 6A specified in the regulations in relation to those kinds of circumstances: [A] treat a Part 6A product (the original Part 6A product) as having ceased to exist at a particular time and [B] from that time, or time determined in accordance with the regulations, treat a class of beneficial interest in the fund that is related to the original Part 6A product as being a new Part 6A product for the purpose of Part 6A.

- inserting a regulation (perhaps after regulation 9AB.5) providing that, for the purposes of the proposed new section, the relevant circumstances exist where a declaration by APRA has been made in relation to the products in question on the basis that APRA considers that the Part 6A product has been restructured to promote the interests of beneficiaries and the making of the declaration appropriate in the circumstances.

Appendix I to this submission includes two alternative options for implementing the policy intent of this recommendation.

Performance benchmarks

We welcome the inclusion of additional indices in the performance benchmarks. However, as outlined in our original submission, the reliance on only one methodology to assess performance, namely utilising indices as proxies for asset class performance, continues to be problematic given the thousands of different investment options with heterogenous underlying assets.

Specifically in relation to the use of the MSCI Australia Quarterly Private Infrastructure Index for the Australian unlisted infrastructure asset class, recent public coverage has outlined a number of significant concerns with this index[1]:

- The composition of the index has changed many times, which has affected reported returns. The inclusion of a new fund in the index in 2019 resulted in a 19.94 per cent increase in the overall net asset (NTA) value of the index. A change in the composition of the index was triggered in May 2020 after seven funds that had not provided data to MSCI were excluded from it. This resulted in a 69 per cent fall in the overall NTA of the index. Another change in composition occurred in August

[1] See AFR article of 19 March 2021: https://www.afr.com/chanticleer/backlash-against-new-super-performance-index-20210519-p57t4w.

2020 when two new funds were included. This resulted in an increase of 125 per cent in the overall NTA of the index.

- The index produced an annual return of 12 per cent over the eight years to March 2021 (including an eight per cent annual return to March 2021- a period covering the COVID-19 disruption to a range of infrastructure assets). This outcome is highly concerning given many of the actual infrastructure assets held by super funds returned materially less than this quantum over the same period.

While we agree with the need for there to be some type of benchmark utilised to objectively assess underperformance across the sector, we reiterate the point we made in our initial submission that a range of approaches should be applied to assess performance to better reflect a holistic consideration, which would support the best interest of beneficiaries. We note that our proposal to incorporate analysis of risk-adjusted investment returns i.e. a forward-looking indicator of performance, has not been adopted.

However, given the important role super funds play in helping to fund Australian infrastructure assets, a role which will increase in national significance as the sector continues to grow, it is critical that YFYS does not unintentionally reduce the appetite for such investments. With the issues noted above in using of the MSCI Australia Quarterly Private Infrastructure Index to benchmark the Australian unlisted infrastructure investment asset class performance, coupled with no use of forward-looking assessment criteria and the serious consequences for underperformance, we believe YFYS will likely reduce the appetite of super funds for such investments, which is not in the best interest of beneficiaries or Australia's economic development.

Performance measures to assess investments into Australian infrastructure assets should be well coordinated and well understood by not only the super sector, but also Government policy-makers to ensure the best interest of beneficiaries will continue to have a positive relationship with Australian economic development. We recognise that the proposed implementation date of 1 July 2021 for YFYS is fast approaching. However, the significance of this issue should warrant closer consideration.

<u>Recommendation</u>

It is recommended that a working group be established with industry (super funds, fund managers, index owners) and government representatives to develop and implement an appropriate index for Australian unlisted infrastructure assets for the purposes of the performance test. Until the index has been implemented, this asset class should be excluded from the performance test.

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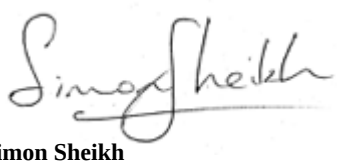
Please contact Mr Fahmi Hosain (fahmi@futuresuper.com.au or 0402 849 221) in the first instance should you wish to discuss any aspect of this submission in further detail.

Yours faithfully,



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APPENDIX I – Other options to address the implications of failing the performance test

1. Apply a modified performance measure to restructured products. This could be done by:

    - specifying a new class of Part 6A product in regulation 9AB.7 for the purposes of subsection 60D(1). The new class of product might be described as a 'restructured product', being a Part 6A product that has been modified with the objective of improving net returns or improving the interests of beneficiaries who hold the product and which APRA has determined should be treated as a 'restructured product' for the purposes of Part 6A; and

    - amending the draft regulations to provide for a modified performance measure to apply to the restructured product which disregards the lookback period unless APRA revokes the determination (which APRA might do if, for example, returns continue to be unsatisfactory on a year-by-year basis).

2. Alternatively, amend draft regulation 9AB.20 (reopening determinations) to allow products to be reopened (under s 60F(4)) where they have been restructured to the satisfaction of APRA (without having to meet the full performance measure currently prescribed in draft regulation 9AB.20(2)). It should be emphasised that this is only a partial solution to the issues noted above because notification of members of a failed assessment would still be required under s 60E. However, consideration could be given to the regulations providing a different form of notification to beneficiaries who hold a restructured product, which advises of APRA's determination in relation to the restructuring of the product and of the intent and objectives of that restructure.

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