ISA submission to the Treasury – Your Future, Your Super Regulations

Executive Summary

The Your Future Your Super (YFYS) reforms have the potential to create a more efficient, fairer superannuation system that would improve retirement outcomes for millions of Australians. However as drafted they fail to protect all Australian workers. Our concerns with the draft regulations are as follows.

Excessive reliance on regulation

- Industry Super Australia (ISA) remains concerned **at the excessive reliance on regulations in the bill**, which undermines parliamentary scrutiny of matters of significant policy substance. These matters must be included in the primary legislation.

Best-financial interest

- The government should **apply a materiality threshold** to the additional record keeping obligations and **undertake a full cost benefit analysis of the cost of this measure**.
- The use of regulations to provide the Minister with the power to ban payments and investments is an unnecessary overreach, not in members best interests, and open to misuse**. It creates an unacceptable and unnecessary level of investment, policy and legal risk**. **The government should remove this regulation making power from the bill.**

Portfolio holdings disclosure

- ISA supports increasing the transparency of assets held by superannuation funds. However, **informing the market of precise asset values could limit their potential sale price.** The government must consider this risk in implementing its Porfolio Holdings Disclosure regime.

Stapling

- The stapling arrangements **must not lock members into underperforming funds**, and must account for insurance arrangements for members in high-risk occupations.
- The stapling proposal will reduce the risk of new unwanted duplicate accounts being created, however more action is needed to deal with the existing stock of duplicate accounts.

Performance testing

- ISA **does not support carve outs on performance testing**. All APRA regulated superannuation products should be subject to performance benchmarking.
- ISA welcomes the government's decision to include administration fees as part of its performance benchmark. However, the benchmark **for all products** should be the median member fee for all MySuper products. **There should not be separate benchmark fees for MySuper and trustee-directed products.**
- **All products should be assessed over 10 years** or if the product has operated for less than 10 years, for the life of the product. **New products should also be subject to performance testing**, but with the default being that they are not automatically subject to consequences from failing to meet the performance benchmark.
- ISA welcomes the government choosing a **more appropriate benchmark for unlisted asset** classes and we support the use of asset-based weighting for assessing lifecycle products' performance.

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About Industry Super Australia

Industry Super Australia (ISA) is a research and advocacy body for Industry SuperFunds. ISA manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of over five million industry super members.

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Feedback

For any questions or comments please contact Thomas McMahon, Senior Manager - Policy & Research (tmcmahon@industrysuper.com).

1. Excessive reliance on regulations

ISA remains concerned at the excessive reliance on regulations to implement important matters of policy substance. The regulations are being used to decide matters such as:

- How the performance of certain products will be tested.
- To which products performance tests will be applied.
- The requirements a fund must meet to be a stapled fund.
- Which payments and investments are banned.

We note that our concerns are shared by others in the parliament. In February, the Senate Standing Committee for the Scrutiny of Bills reported on the Your Future, Your Super bill. It considered the government's explanation that certain important matters needed to be in regulation to afford necessary flexibility in response to "evolving industry practices." It concluded:

> "The committee's view is that significant matters, such as basic requirements about default arrangements for superannuation payments [i.e. stapling], should be included in primary legisaltion unless a sound justification for the use of delegated legisaltion is provided…
>
> the committee has generally not accepted a desire for administrative flexibility to be a sufficient justification, of itself, for leaving significant matters to delegated legislation…
>
> The committee notes that a legislative instrument, made by the executive, is not subject to the full range of parliamentary scrutiny inherent in bringing proposed changes in the form of an amending bill."[1]

The committee asked the Treasurer to explain why it was considered appropriate to leave certain basic requirements to delegated legislation. In his reply the Treasurer reiterated his argument based on flexibility, while adding that it was appropriate to delegate "technical matters" relevant to performance testing to regulations.[2]

While noting the Treasurer's response, the committee did not agree that there was sufficient justification for leaving significant matters to delegated legislation when detail could have been provided in the explanatory memorandum. In relation to the performance test the committee concluded that:

> "…it is inappropriate for details in relation to the operation of the proposed annual performance test to be set out in promotional materials, but not in explanatory materials tabled in the Parliament."[3]

[1] Standing Committee for the Scrutiny of Bills, Scrutiny Digest 4 of 2021, p. 10.
[2] Treasurer's letter to Senator Helen Polley, Chair of the Senate Scrutiny of bills Committee, 25.03.21
[3] Standing Committee for the Scrutiny of bills, Scrutiny Digest 6 of 2021, p. 88.

The committee concluded by drawing its continuing concerns to the attention of the Senate and to the Senate Standing Committee for the Scrutiny of Delegated Legislation. We understand that the Delegated Legislation Committee will review the regulations, but only after the present consultation process has been completed and the final regulations decided.

We would add that it is misleading to characterise the performance testing methodology as "technical matters", which can therefore be left to regulations. This suggests that the construction and application of the methodology is a neutral technical exercise in mathematics and statistics.

However, in the context of measuring the performance of superannuation products the choice of assumptions, and what data to include and exclude, can have significant implications for determining which products are found to be underperforming and what action (if any) will then be taken to protect the interests of members. These are contestable matters that should be subject to parliamentary scrutiny and, where necessary, amendment.

We discuss important concerns we have about the proposed performance testing methodology later in this submission. In sum, the excessive reliance on regulation by the government has served to undermine parliamentary scrutiny of matters of significant policy substance.

ISA recommendation: The government should include matters of policy substance, including the matters identified by the Scrutiny of Bills Committee, in primary legislation.

2. The Best Financial Interests Duty

The regulations which have been released in exposure draft completely omit provisions and requirements related to the main provisions (Part 1) of Schedule 3 of the bill. Instead, the exposure draft regulations relate only to Part 2 of Schedule 3 of the bill which in the case of portfolio holdings disclosure requirements, were not part of the original YFYS announcement[4] nor exposure draft consultation[5] on the legislation.

In the absence of any exposure draft regulations on the enhanced best financial interests duty, ISA makes the following observations consistent with our previous submission on the exposure draft legislation.

Demonstrating compliance with the best financial interests duty

ISA agrees that all expenditure and investments by trustees must be in the best financial interests of members and subject to appropriate record keeping. However, the government's approach to enforcing this obligation - a reversed evidentiary burden, no

[4] See: https://treasury.gov.au/sites/default/files/2020-10/p2020-super_0.pdf
[5] See: https://treasury.gov.au/consultation/c2020-124304

materiality threshold and a strict liability offense - comes at an additional cost to members with no demonstrated additional benefit.

The *Superannuation Industry (Supervision) Act 1993* empowers the government to prescribe operating standards through regulations about record-keeping by trustees of expenditure. No standards have been prescribed and yet the bill makes failure to comply with these record-keeping obligations a strict liability offence. It does not require APRA to prove fault on the part of the trustee.

Given that the law does not set a materiality threshold for expenditure and places the evidentiary burden on trustees to show a reasonable likelihood that expenditure was in members' best financial interests, trustees will need to install extensive systems and processes to avoid liability for failing to maintain records of payments, no matter how small.

The absence of a materiality threshold for the additional record-keeping obligations placed on funds is expected to add tens of millions of dollars to trustee running expenses which in turn will reduce returns to members. There is no magic source of additional revenues from which these expenses can be paid. Ultimately all expenses are charged to members.

The figure used in the explanatory memorandum for the industry-wide compliance cost for the entire YFYS package of $5.1 million is absurd. Initial estimates by ISA member funds suggest this grossly underestimates the true compliance cost with one fund alone providing a preliminary estimate of between $600,000 - $1 million for compliance costs. If replicated across each RSE entity the compliance cost could easily exceed $100 million. We again request the government undertake a thorough regulatory impact analysis—including a cost benefit analysis—of the cost of the proposals.

ISA recommendation: The government should apply a materiality threshold to the additional record keeping obligations placed on funds through operating standards and undertake a full cost benefit analysis of the cost of this measure.

Prescription relating to payments and investments

ISA continues to believe the use of regulations to ban payments and investments that are in members' best financial interests is an unnecessary overreach, not in members best interests, and open to misuse. The explanatory material to the bill fails to give any example or identify any circumstances where payments or investments may be considered unsuitable and require a new power to be prohibited. The draft regulations also fail to offer examples of payments or investments that could be banned.

The bill permits trustees to lawfully make certain decisions about payments and investments which can be demonstrated to be in the best financial interest of members. Yet by allowing unfettered powers for regulations to be made to prohibit those payments or investments, or to impose additional requirements on trustees when exercising their duties, the bill introduces an unacceptable and unnecessary level of policy and legal uncertainty for trustees and undermines the proper exercise of trustees' duties. The absence of any regulations only entrenches this uncertainty.

The government's justification for this regulation making power is that it will provide it with the necessary flexibility to make timely amendments in response to changing risks. If a quick response is needed, then APRA is the appropriate body to do this given its extensive powers. APRA's existing directions powers[6] in conjunction with the ability to make and enforce prudential standards and guidance is more than sufficient to ensure trustees make payments and investments that are in the best financial interest of members.

Further, as noted above in this submission, leaving important matters of substance such as banning payments and investments to delegated legislation shifts important debate and oversight away from the parliament. This is a matter raised by the Standing Committee for the Scrutiny of Bills whose concerns are yet to be resolved.

ISA recommendation: The government should remove from the bill the power to make regulations prohibiting or placing conditions on payments and investments and placing additional requirements on trustees.

3. Portfolio Holdings Disclosure

ISA supports increasing the transparency of assets held by superannuation funds to be provided through Portfolio Holdings Disclosure and welcomes regulations setting out how the information is collected and displayed. It is however important that members' interests are not adversely affected in pursuit of transparency.

Unlisted assets are more sensitive to disclosure of their market value, for example, infrastructure, real property and private equity. Providing a value for each unlisted asset informs the market of a potential sale price for that asset and consequently limiting the price that can be achieved because buyers will anchor to the disclosed price. The effect is to limit the potential upside and in doing so, reduce the financial return for members. This issue has been raised by industry funds with Treasury on numerous occasions and ignored, despite the fact that an appropriate regulation making power to address this issue already exists.[7] In the same way that individuals would never disclose the reserve price of their house before they took it to auction, the proposed legislation risks harming members' financial interests by disclosing the reserve price of unlisted assets.

To address this concern there are two options for disclosing of the value of unlisted assets in ways that will protect the interests of members:

- Allow each unlisted asset to be separately identified but provide only an aggregated value for the group, or
- Allow the value for each unlisted asset to be disclosed as a range instead of a single dollar value.

[6] See SIS Act s 131D
[7] See Corporations Act s 1017BB(1A)

Both options provide disclosure to members and the market about the specific assets in which the fund is invested with either an aggregate value for the group or a range for individual assets. In doing so they provide transparency of the holding without limiting the sale price of unlisted individual assets.

Finally, we expect that some funds may find compliance with the detailed disclosure requirements challenging in the time frame proposed and may need to seek relief from ASIC.

ISA recommendation: The government must protect members' interests and consider the risks associated with funds disclosing the individual values for unlisted assets.

4. Single Default Account/Stapling

ISA supports measures that will mean members do not unintentionally hold multiple accounts. As noted in our submission in response to the draft bill, our preferred model of achieving this involves a member being stapled to their balance, which, unless they choose to retain their account, automatically rolls-over into a new quality checked account when they join a new employer.[8]

The bill aims to limit the creation of multiple accounts for employees who do not choose a superannuation fund when they start a new job. Amendments in Schedule 1 to the bill mean that if a new employee (who has started a new job on or after 1 July 2021) has not chosen a fund but has an existing "stapled" fund, the amendments will in part allow the employer to comply with the choice of fund rules by making contributions to the employee's "stapled fund".

The draft regulations support the amendments in the bill in part by setting out the requirements that a fund must meet to be a "stapled fund". These requirements include that a stapled fund must be a complying superannuation fund, and that the employer will likely to be able to make contributions on behalf of the employee into the stapled fund.

However, there are several significant weaknesses with how the bill and regulations define a stapled fund and how they deal with the issue of insurance for those in dangerous or high-risk occupations.

In addition, early commencement of these provisions before systems are built will place inappropriate additional administrative costs on employers who will need to manually check a new employee's super account with the ATO rather than the employee being given the opportunity to supply those details under the current choice of fund provisions.

Performance

[8] A report by KPMG on the benefits of this model of stapling can be found here: https://www.industrysuper.com/media/stapling-of-superannuation-accounts-an-independent-analysis-by-kpmg/

It is proposed that an employee will be stapled to their existing product regardless of whether that product has passed an annual APRA performance test.

As we noted in our submission on the bill, this is a perverse outcome given that a key aim of the policy package is to improve retirement outcomes. There is a considerable risk that disengaged and low-information members (the majority according to the Productivity Commission) will be stapled to a relatively poor fund and remain there for too long with harmful financial consequences.[9] Coupled with the carveouts for performance benchmarking on most Choice superannuation products such members will never be informed they are in an underperforming product. The consequence that members will be handcuffed to underperforming products is perverse and completely at odds with the bill's objectives.

ISA recommendation: To better protect members the bill and the regulations should be amended to require that only a fund that has passed the annual APRA performance test should be eligible to be a stapled fund. Stapling should only commence after automatic systems are available and performance benchmarking commences for all funds and products.

Appropriate insurance

As we noted in our submission on the draft bill, stapling members to products risks them being stapled to products that do not provide appropriate insurance for the occupations they perform. This is a significant risk for those who move from a low-risk to a high-risk industry, but who continue to pay for insurance as part of the product they have been stapled to that is unlikely to cover them for the new/heightened risks they confront.

This problem has previously been recognised by the government in the context of the Putting Members' Interests First reforms that led to the inclusion of a "dangerous occupation" exemption.

Unfortunately, the bill – and now the draft regulations – fail to acknowledge this problem and the potential solutions to it. However, it is clearly in the interests of members that they are not stapled to products with insurance that does not meet their needs.

ISA recommendation: The bill and the regulations should be amended to include a safeguard for employees who work in dangerous or high-risk occupations.

More action needed on multiple accounts

The key rationale for the government's current stapling proposals is the need to tackle the erosion of members eventual retirement incomes derived from super because of unintended multiple accounts.

[9] Productivity Commission, Superannuation Inquiry Final Report, p. 21.

However, there are no current proposals from the government to deal with the existing stock of multiple accounts. Some low balance inactive accounts will be dealt with under the Protecting Your Super and Reuniting More Superannuation Act. However, the ATO is not proactively consolidating inactive savings to members' active accounts where that balance is less than $6,000. This results in members' accounts taking longer to obtain a scale where fees are less likely to erode savings. Regulations should be amended to ensure the ATO consolidates all monies it holds to members' active accounts. Furthermore, we note the Productivity Commission recommended increasing the balance threshold for auto-consolidation over time unless there were compelling reasons not to do so (Recommendation 5). The government has yet to accept this recommendation or to make alternative proposals.

ISA recommendation: The bill and regulations should be amended to require the ATO to automatically consolidate all ATO held superannuation monies to members' most recent active superannuation account, and the government should consult on increasing the balance threshold for auto-consolidation of superannuation accounts.

5. Performance testing

ISA supports the broad policy intention of the measures to address underperformance in superannuation. We believe that all Australians deserve to be in a high performing fund.

As we mentioned at the start of this submission, we believe that key features of the policy should be defined in primary legislation rather than via regulation. While aspects of the performance benchmark, such as which indices are used for which asset classes may be appropriate for regulation, the following features should be defined in legislation to provide for certainty and proper parliamentary scrutiny:

- The defintion of returns that will be measured under the performance testing framework;
- Which products are covered; and
- The time period for assessing performance.

Product coverage

ISA does not support carve outs on performance testing for member-directed or single asset products. As we noted in our submission to the Senate legislative inquiry into the bill, the Productivity Commission clearly stated that it considered trustees are ultimately responsible for the products that they design and offer to members.[10]

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

[10] Superannuation: Assessing Efficiency and Competitiveness – Inquiry report (December 2018), p 115.

offered to members…that should be the focus of regulatory attention."[11] The Commission continued:

> "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…"[12]

We strongly recommend that the primary legislation be amended to ensure that all APRA regulated products are covered by performance testing. As this is a core feature of the operation of the Your Future, Your Super legislation it should not be delegated to regulation.

ISA recommendation: All APRA regulated superannuation products (other than defined benefit products) should be subject to performance benchmarking. This should be specified in the primary legislation rather than regulation.

Net returns

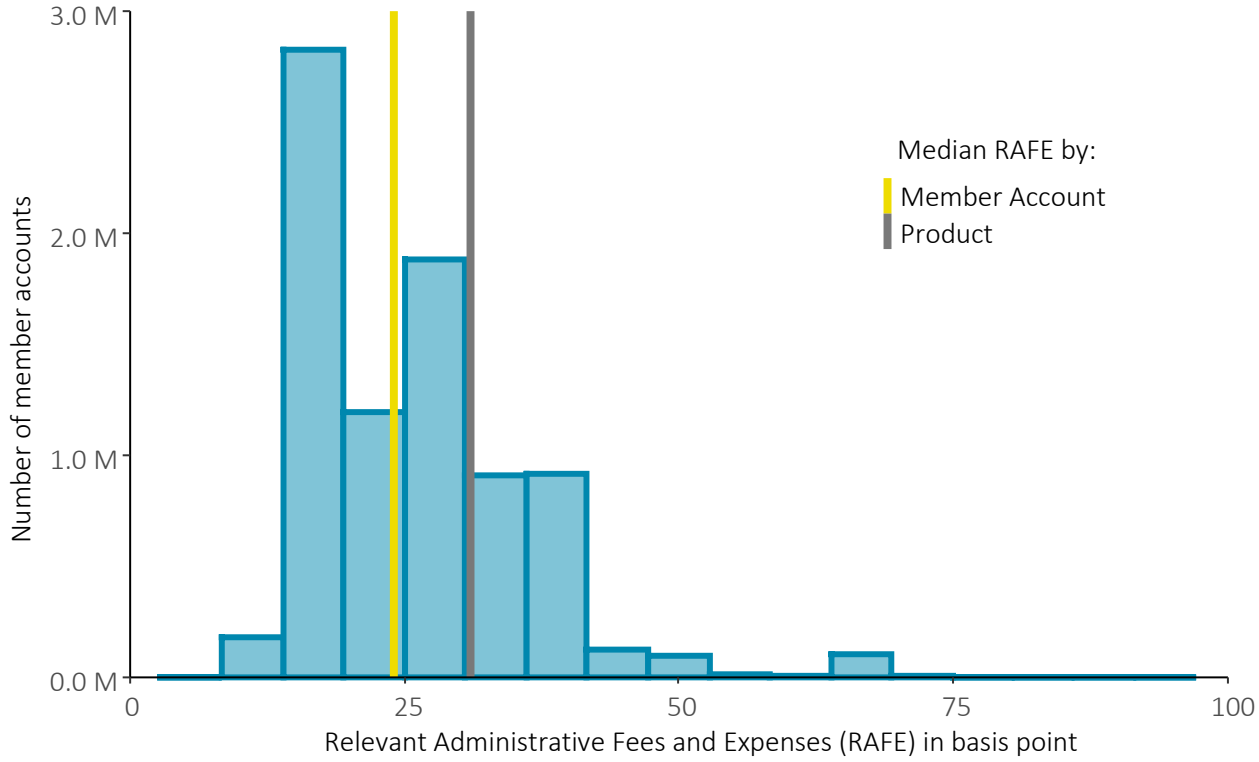
ISA welcomes the government's change of heart on the inclusion of administration fees as part of its performance benchmark. As we argued in our previous submissions on this package, performance benchmarking should assess the outcomes received by members in their accounts – that means the benchmarking should include investment performance but also, other things like administration fees. The proposed inclusion of "Relevant Administration Fees and Expenses" (RAFE) is appropriate. However, we believe that the benchmarks could be further strengthened.

The draft regulations state that the construction of a product's benchmark return involves deducting the median *product* RAFE from the product's net investment return. ISA believes that the more appropriate benchmark is the median member account RAFE across all APRA super regulated MySuper products, rather than the median product RAFE as proposed.

This is because superannuation member accounts and funds are not evenly distributed across products, the largest MySuper products have more than 200 times more members than the smallest products.[13] The number of products is also unstable and subject to change. We believe that using the median member fee would better reflect the representative typical fees paid by members reflecting the benefits of scale. Figure 1 shows the distribution of MySuper member accounts by RAFE, which shows that the median member RAFE of 24 basis points is 7 basis points lower than the median product fee.

[11] Superannuation: Assessing Efficiency and Competitiveness – Inquiry report (December 2018), p 491.
[12] Superannuation: Assessing Efficiency and Competitiveness – Inquiry report (December 2018), p 492.
[13] The median number of member accounts for the top 10 MySuper products compared with bottom 10 MySuper products by member accounts. APRA Annual MySuper data, December 2020

Figure 1 Distribution of MySuper member accounts by RAFE



Source: ISA analysis of APRA Quarterly MySuper data, December 2020

The draft regulations also indicate that there will be a different RAFE benchmark for MySuper and trustee-directed products. Putting aside our view that the performance benchmarks should apply to all APRA regulated superannuation products, we do not believe that there is a strong rationale for a separate administrative fee benchmark for different product types.

There is no proposal advanced for different investment fee benchmarks for the same asset class between different products as these fees should properly reflect an efficient market cost. The same rationale holds for administrative fees on different accumulation products although there may be a case for slightly higher fees for retirement products where the regular payment of benefits via income streams incur additional costs.
Using a separate administrative fee benchmark for non-MySuper products may inappropriately entrench high fees with significant profit margins. This would be at odds with the stated objectives of the reforms.

While there is a lack of comprehensive data on choice products, we expect that administrative fees are likely to be significantly higher for trustee-directed products. These products are much more likely to be retail products, which have higher administrative fees than not-for-profit funds. The median member weighted retail super product administrative fee is 50 basis points, 26 basis points higher than the overall MySuper median fee. If trustee-directed products are allowed to charge higher fees, then this will have a material impact on member retirement balances.

Given the sensitivity of the performance testing to the definition of net returns, it should be defined in the primary legislation and not be left to regulation.

ISA recommendation: The benchmark RAFE should be based on the median member RAFE for all APRA regulated MySuper products. There should not be a separate RAFE for trustee-directed products. This should be specified in the primary legislation rather than regulation. If retirement products are included in the performance benchmarking framework a small additional administrative fee may be warranted given the additional account keeping requirements of income stream or annuity products.

Product assessment timeframes

ISA recommended 10-year timeframes for performance benchmarking to reduce the risk of false positives in our previous submissions to Treasury and the Senate Inquiry. An 8-year performance period as proposed by the draft regulations is too short. The Conexus Institute investigated the effectiveness of the proposed eight-year period for identifying underperforming funds. It found that for every six "poor" funds, this test will likely mis-identify one as a good performer because over eight-year intervals a poor fund may experience annualised performance above the threshold level. [14] This is an unacceptably high risk of false positives.

Support for a longer performance period for assessing returns is found on the Government's own MoneySmart website. The explanation given about how to choose investments uses a ten-year time frame to show average returns.[15] ISA also notes that the product dashboard requirements for MySuper products in the *Corporations Act 2001* require funds to work out a return target[16] for a period of ten years and the return for the previous ten financial years, or the period the product was offered. There is no reason for the period over which performance is assessed in the YFYS reforms to differ from the product dashboard requirements.

ISA recognises that new products should not immediately face consequences for underperformance, as the benchmarks are unlikely to be accurate in the short term. However, it is not appropriate that products that have less than five years of performance are completely exempt from performance testing. We think that it would be appropriate for new products to be subject to performance testing, but with the default being that they are not automatically subject to consequences from failing to meet the performance benchmark (subject to the materiality of that underperformance). APRA should be able to exercise discretion as to whether a product should face consequences from failing to meet the benchmark.

[14] https://theconexusinstitute.org.au/wp-content/uploads/2020/11/YFYS-Detailed-Paper-20201127.pdf, p 19-p20

[15] https://moneysmart.gov.au/how-to-invest/choose-your-investments

[16] The return target is the mean annualized estimate of the percentage rate of net return of a representative member that exceeds growth in the consumer price index over ten years.

In exercising its discretion, APRA should take into consideration the magnitude of underperformance into account, as well as any links to other products that have failed to meet the benchmarks as outlined in the explanatory material.

ISA recommendation: The legislation should specify that all products should be assessed over 10 years or if the product has operated for less than 10 years, for the life of the product.

For products that have less than five years of performance history, consequences should not apply to failure to meet the benchmarks, unless APRA assesses that to do so would be in members' best financial interest.

Indices

ISA argued against the use of listed indices to benchmark unlisted asset classes in our previous submissions. We welcome the government choosing a more appropriate benchmark for these asset classes. While there are issues with the price of accessing the underlying index, and transparency on how the index is constructed, on balance we believe it is an improvement over the previously proposed listed index.

Lifecycle products

ISA supports the use of asset-based weighting for assessing lifecycle products. Separately evaluating the performance of each individual stage of a lifecycle product not only adds complexity but also inappropriately incentivises bait and switch product structures were certain life-stages (for example younger cohorts) might be structured to perform reasonably well but then performance deteriorates in subsequent life stages. Given that superannuation is an investment product with a medium to long-term investment horizon, it is vital that whole of product performance is the relevant metric for performance assessment and consumer disclosure on the proposed MySuper comparison website.

List of recommendations

1. **Excessive reliance on regulations**

   ISA recommendation: The government should include matters of policy substance, including the matters identified by the Scrutiny of Bills Committee, in primary legislation.

2. **The Best Financial Interests Duty**

   ISA recommendation: The government should apply a materiality threshold to the additional record keeping obligations placed on funds through operating standards and undertake a full cost benefit analysis of the cost of this measure.

   ISA recommendation: The government should remove from the bill the power to make regulations prohibiting or placing conditions on payments and investments and placing additional requirements on trustees.

3. **Portfolio Holdings Disclosure**

   ISA recommendation: The government must protect members' interests and consider the risks associated with funds disclosing the individual values for unlisted assets.

4. **Single Default Account/Stapling**

   ISA recommendation: To better protect members the bill and the regulations should be amended to require that only a fund that has passed the annual APRA performance test should be eligible to be a stapled fund. Stapling should only commence after automatic systems are available and performance benchmarking commences for all funds and products.

   ISA recommendation: The bill and the regulations should be amended to include a safeguard for employees who work in dangerous or high-risk occupations.

   ISA recommendation: The bill and regulations should be amended to require the ATO to automatically consolidate all ATO held superannuation monies to members' most recent active superannuation account, and the government should consult on increasing the balance threshold for auto-consolidation of superannuation accounts.

5. **Performance testing**

   ISA recommendation: All APRA regulated superannuation products (other than defined benefit products) should be subject to performance benchmarking. This should be specified in the primary legislation rather than regulation.

   ISA recommendation: The benchmark RAFE should be based on the median member RAFE for all APRA regulated MySuper products. There should not be a separate RAFE for trustee-directed products. This should be specified in the primary legislation rather than regulation. If retirement products are included in the performance benchmarking framework a small additional administrative fee may be warranted given the additional account keeping requirements of income stream or annuity products.

   ISA recommendation: The legislation should specify that all products should be assessed over 10 years or if the product has operated for less than 10 years, for the life of the product.

For products that have less than five years of performance history, consequences should not apply to failure to meet the benchmarks, unless APRA assesses that to do so would be in members' best financial interest.