Mercer

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Ben Dolman
Director, Member Outcomes and Governance Division
Treasury
Langton Cres
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Subject: **Faith-based and other superannuation products**

Dear Ben

Thank you for the opportunity to provide feedback on the exposure draft legislation and explanatory material relating to the performance test treatment of faith-based superannuation products.

The context

Australian superannuation has recently celebrated the 30th anniversary of the introduction of the Superannuation Guarantee from 1 July 1992. It has been a remarkable success and has ensured that many Australians have a higher quality of life during their retirement. The Retirement Income Review found that the Australian retirement income system is effective, sound and its costs are broadly sustainable.

One of the consequences of this success has been that an increasing number of Australians are showing greater interest in where their superannuation assets are invested. This interest can arise for several reasons which could include their:

- religious faith
- concerns relating to climate change and other environmental issues
- concerns relating to social issues such as human rights and slavery
- concerns about the treatment of, and the prevention of cruelty to, animals

This range of interests and philosophies means that many Australians are making choices about their superannuation investments. This is a good outcome and should be encouraged. The members are involved and engaged with their future and want to invest in a manner consistent with their personal principles and morals.

Australia is a successful multi-cultural society and this social and cultural diversity is now being seen in the superannuation industry. The APRA Performance Assessments need to recognise and support the choices made by Australians.

For example, many Australians are now concerned with the impact of climate change and do not want their superannuation fund to invest in companies associated with carbon intensive fossil fuels.

Responding to these interests, more superannuation funds are offering investment options that exclude investments in certain industries. Yet, during some periods, these "excluded" stocks may perform very well due to global issues such as an energy shortage. In such circumstances, it would be inappropriate to test the performance of a particular product against a general market index where the individual has made a clear choice.

It is also worth noting that some of these selected investment strategies will have a higher cost structure than a passive investment approach due to the extra work involved in managing a portfolio which must screen out certain investments. Hence, the benchmark used for such tests needs to recognise the potential for additional costs to follow the member's choice.

These comments stress the importance of choices and decisions made by individuals and therefore, the need for legislation and superannuation funds to respect such choices.

Of course, we recognise that many Australians are not engaged with their superannuation to the extent discussed above, and are invested in the relevant MySuper (or default) product. Therefore, we are not suggesting the proposals put forward here would apply to the performance tests for MySuper products. Rather, we are recommending that where individuals have made a choice, then it is appropriate to have a different approach from that adopted for MySuper products.

The approach when individuals make choices

Our understanding is there will shortly be no faith-based MySuper products that appear obvious candidates to seek faith-based status as Christian Super (which failed last year's performance test) is transferring to Australian Ethical and Crescent Wealth does not have a MySuper product.

Hence, in our commentary and recommendations below, we have adopted a broader perspective than might apply to faith-based products only. In brief, we recommend that the general approach adopted for faith-based products should be able to be adapted to a broader range of superannuation products where individuals have made choices based on their personal faith, principles or morals. We have therefore denoted faith* below to incorporate this broader definition.

Commentary on the draft legislation and explanatory memorandum

In light of the above comments, Mercer supports the proposals for:

- a supplementary test should a faith*-based product fail the original test
- trustees to apply for such a test to be used in respect of their selected product(s)
- trustees to suggest to APRA one or more indices that would be relevant to assess the product's performance
- the trustee's public disclosures to be consistent with the chosen investment strategy for each product
- APRA to monitor the actual investments to ensure they are consistent with the product's published investment strategy
- APRA to have the right to make and revoke the relevant determinations

The ability to apply for classification as a faith*-based product by APRA appears to be dependent on the trustee being able to identify one or more alternative benchmarks that it (and presumably APRA) consider suitable to use in the supplementary performance test. There does not appear to be an avenue for an application where no alternative benchmarks are sufficiently aligned with the investment strategy adopted. Hence, trustees may be forced to nominate a poorly aligned benchmark in order to access the supplementary test.

Mercer also suggests that the margin for failing the supplementary test should be increased from 50 basis points to 75 or 100 basis points recognising that each of these products have special characteristics such that there will be additional costs relating to the chosen investment strategy. In addition, in many cases, the best benchmark available is unlikely to match closely the chosen investment strategy as occurs with less specialised investment strategies. A larger margin is therefore appropriate.

Alternatively, attribution analysis could be used to determine the level of performance variation from the benchmark arising due to investing in the underlying assets which align with the faith*-described options. The standard (or nominated alternative proxy) benchmark could then be adjusted by this amount before applying the test.

Consequences of failing

Mercer recommends that the consequences of a faith-based product failing both tests should be different from those applying to MySuper products that fail the test. In particular, we recommend that:

- The letter sent to members notifying them of the failure should highlight the failure to pass the test (that is, the underperformance) and state that members should consider alternative products. However, it should also say that:
    - Members should be aware that like-for-like comparisons can only be made against products with a similar risk/return profile and similar faith* restrictions on investments.
    - If a better-performing product with similar restrictions on investments is not available, then the member may wish to remain in that product due to their faith*.
- The prohibition on new members investing in a product which fails the performance test in two consecutive years should not apply to approved faith*-based products unless APRA determines that the failure is not predominantly due to the faith*-based restrictions on the investments.

Catering for other specialist investment strategies

We note that the upcoming Treasury review of the operation of the Your Future, Your Super (YFYS) laws will include consideration of how the performance test should be applied to Choice superannuation products.

We suggest that this should include consideration of how the performance test should be applied to non-faith*-based specialist investment strategies for which the standard performance test benchmarks are unsuitable. These would include investment strategies which seek to provide lower risk through fixed interest portfolios focused on short-to medium term securities, share portfolios focused on low volatility stocks or portfolios that follow particular ESG approaches not captured by the faith*-based definition.

Of course, the public disclosures relating to such investment strategies must be consistent with actual practice.

Who is Mercer?

Mercer is one of the world’s leading firms for superannuation, investments, health and human resources consulting and products. Across the Pacific, leading organisations look to Mercer for global insights, thought leadership and product innovation to help transform and grow their businesses. Supported by our global team of 22,000, we help our clients challenge conventional thinking to create solutions that drive business results and make a difference in the lives of millions of people every day.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $280 billion in funds under administration locally and provide services to over 2.2 million superannuation members and 15,000 private clients, including the Mercer Super Trust, which has around 230 participating employers, about 200,000 members and more than $29 billion in assets under management.

Naturally, we would be happy to discuss this submission with you or your team at your convenience.

Yours sincerely,

Dr David Knox
Senior Partner