Industry Super Australia

Your Future, Your Super Review

Summary of our submission

Industry Super Australia (ISA) is a collective body for funds that carry the Industry SuperFund symbol. ISA manages research, advocacy and collective projects on behalf of those funds and their five million members. Our aim is to maximise the retirement savings of all our members.

ISA broadly supports the intention of the Your Future, Your Super reforms to create a more efficient and fair superannuation system that improves the retirement outcomes of Australian workers. However, since the reforms have been implemented, it has become clear that they are not achieving their objectives in a way that is effective and proportionate.

Performance test

An objective test of product performance is critical to a well-functioning superannuation system. However, the current test does a poor job of measuring members' financial outcomes. It does not assess or provide information about products that do well to both lower risk and generate good long-term returns, and there is ample evidence of gaming when funds select benchmarks and set fees. Our recommendations about the test methodology and presentation of metrics will be provided in a separate submission.

Relying on members to move out of poor performing products is not working. And some products that are passing the test are only barely doing so. Information about performance test outcomes is not presented to consumers in a way that identifies products that are adding value to members and those that are losing them money. There needs to be tougher consequences for failing or only just passing the test, to better protect members from underperforming products.

The failure of the test to extend to all products in the superannuation system, including retirement products, leaves many members in products that are not held to account.

YourSuper comparison tool

The YourSuper comparison tool has the potential to assist consumers who want to engage with their superannuation. However, the current tool provides various opportunities for users to be misled – for example, due to the default sorting method. This undermines the objective of the tool, which is to empower members to make informed decisions about who manages their retirement savings.

Stapling

The stapling model has created serious and entirely foreseeable issues, such as members being stapled to underperforming products and members in dangerous occupations retaining inadequate (or no) insurance coverage through superannuation. This is not in the best interests of members and is not a

proportionate response – particularly when there are other models that can be used to prevent the creation of new unintended multiple accounts, while also dealing with existing ones and connecting disengaged members to high quality products rather than having them languish in underperforming products.

Best financial interests duty

Finally, 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 approach taken by the Government and the regulator in relation to the best financial interests duty (BFID) has resulted in significant and unnecessary expenses and opportunity costs, which are ultimately borne by members.

BFID also fails to focus on expenditure and activities that most affect members' financial outcomes. It ignores payments of profit, which previous reviews have shown can be significant and assumes that 'essential' payments require less justification, despite them being one of the largest fund expense components and evidence showing that core service provider arrangements with related parties are set on terms that disadvantage members.

To better target the measures and improve retirement outcomes for more members, ISA makes the following recommendations, noting our recommendations about the test methodology and presentation of metrics will be provided in a separate submission.

Performance test

1. The legislation should prescribe that a product that has failed the performance test two years in row must not accept any new members and must transfer any existing member accounts to a product that exceeds the test within a reasonable timeframe.
2. The Government should amend the performance test outcomes and apply proportionate consequences depending on the relevant outcome.
3. In communications to members about failing the performance test, funds should be able to include information about an agreed merger if there is a reasonable expectation that the merger will take place in the next 12 months.
4. All APRA-regulated superannuation products (other than defined benefit products) should be subject to performance benchmarking.

YourSuper comparison tool

5. The tool should be subject to rigorous and comprehensive consumer testing. This testing should cover the inclusion of a metric that allows for a monetary comparison to be made between products, based on performance test scores.
6. The tool should by default sort products from highest long-term net returns to lowest long-term net returns. For lifecycle products, net returns should be shown as a single product level return (asset weighted by life stage).
7. The tool should show whether the product exceeds, passes, or fails the performance test and should allow products to be ranked by their test score.

8. The tool should include information about either the cost of default insurance premiums against the cover provided or the default level of cover. The tool should also let users know whether the product has adopted the dangerous occupation exemption under the Putting Members' Interests First legislation.

9. Inconsistencies between the tool and the product dashboards should be minimised to reduce the risk of confusion for members.

10. The limitations of the tool should be set out more clearly.

11. The tool should be extended to include choice products and the choice product dashboard regime should commence.

12. A comparison tool should be developed for retirement products.

Stapling

13. The Government should transition the current stapling model with one that is based on the automatic rollover and consolidation of balances in instances where members do not actively choose a fund. The first steps in transitioning the stapling model are set out in our next two recommendations.

14. The meaning of "stapled funds" in section 17A of the *Superannuation Guarantee (Administration) Regulations 2018* should be amended so that in addition to the existing rules, a fund can only be a stapled fund for an employee if the employee's interest in the product offered by the fund has passed the most recent performance test. If the relevant product has not been tested, the fund cannot be the stapled fund for the employee.

15. Members in dangerous occupations or undertaking dangerous work activities should be excluded from the stapling reforms.

Best financial interests duty

16. The Government should apply a materiality threshold to the additional record keeping obligations related to the best financial interests duty.

17. APRA should provide clear guidance on how expenses should be justified and what records should be kept.

18. The level of scrutiny should be proportionate to the scale of the expenditure and the impact on member outcomes.

19. Payments to related parties, including dividend or profit payments, should be disclosed to APRA, fund members and the public. Where such payments are material, trustees must keep records about how those payments are in the best financial interests of members.

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Performance test

Our recommendations about the test methodology and presentation of metrics will be provided in a separate submission.

Consequences of failure

Too few members in products that fail the performance test are switching into better performing products. APRA data to 2 February 2022 indicate only 6.4 per cent of members (accounting for 6.2 per cent of assets) had exited their underperforming MySuper product that had failed the 2021 performance test some five months earlier.[1]

Additionally, too many members are in products that have passed the test but deliver relatively poor returns. The data show significant differences between the performance of top-performing versus poor-performing products. Figure 1 below shows there can be a greater than 300 basis point difference in net returns enjoyed by members in the best and worst performing products that pass the test.

Remaining in a poorly performing product has significant implications for members' retirement outcomes. ISA analysis suggests that members who remained in their underperforming products collectively lost $1.6 billion in the 12 months to June 2022, compared with where they could have been if they switched to a high-performing fund a year earlier.[2]

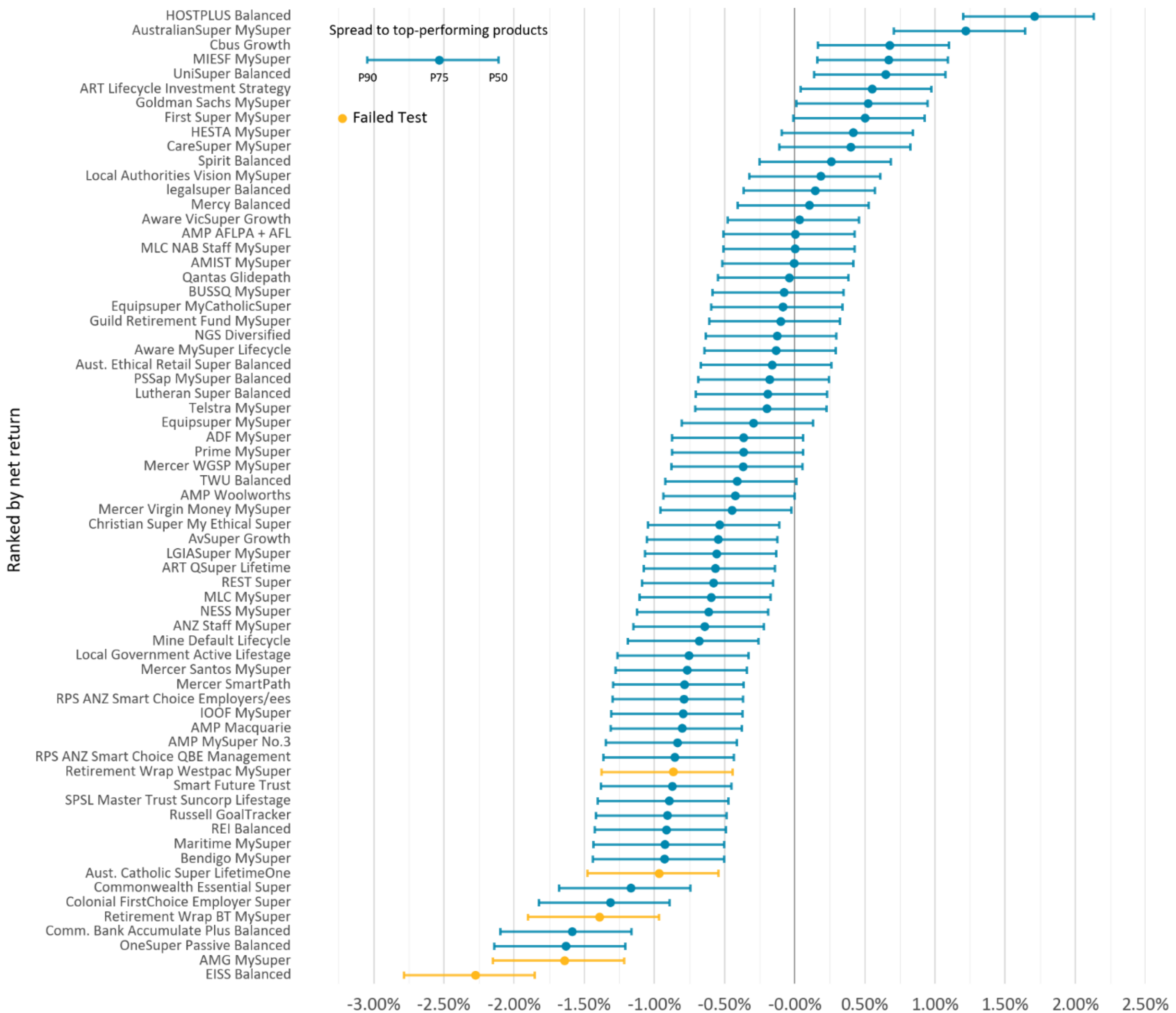
This shows that relying on members to make well-informed, good decisions is not enough to improve their retirement outcomes. This is consistent with the Productivity Commission's finding that many members – in both MySuper products and choice products – are either disengaged from their super or actively make poor/uninformed decisions.[3]

In our view, more is needed to ensure that members are not left languishing in underperforming funds. Our recommendations below aim to improve outcomes for members in underperforming funds, by:

- imposing tougher consequences on products that fail the performance test two years in a row, and
- ensuring it is easy for members who are interested in engaging with their super to access simple, clear, and accurate information about fund performance (noting our recommendations about the YourSuper comparison tool are also relevant here).

[1] APRA, *Answers to questions on notice at Senate Estimates on 28 October 2021* (14 February 2022).
[2] We estimate that around 850,000 members remained in an underperforming MySuper product. We compared the asset-weighted 1-year return to June 2022 of these underperforming products relative to the asset-weighted 1-year return of the top 10 MySuper products, ranked by their 7-year net returns to June 2021. That is, it is an ex-ante test that compares the outcome of remaining in an underperforming product versus switching to a high-quality product based on information available at the time.
[3] Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness Inquiry Report* (21 December 2018).

Figure 1: ***Spread between average annual product net returns***
MySuper 90th, 75th and 50th percentiles, 8 years to June 2022



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual Superannuation Performance Test – 2022, APRA Quarterly Superannuation Performance Statistics (June 2022).
Note: The figure measures the difference between the product's average annual net return over the past 8 years and the: 90th percentile (left limit of the line), 75th percentile (dot), 50th percentile (right limit of the line). For example, net returns for the worst performing product have been, on average, 2.8 per cent per annum below the 90th percentile, 2.3 per cent per annum below the 75th percentile, and 1.9 per cent per annum below the median.

Tougher consequences for products that fail the performance test two years in a row

We acknowledge that in addition to the consequences in the performance test legislation, APRA has extensive supervision and enforcement powers it can use – and has used – to deal with underperforming products.

However, ISA supports tougher consequences for products that have persistently and chronically underperformed, and for those consequences to be set out in the legislation.

In particular, the legislation should prescribe that a product that has failed the performance test two years in a row must not accept any new members and the fund must transfer any existing member accounts to a product that exceeds the test, within a reasonable timeframe. A reasonable timeframe is one that is in the best interests of members in the underperforming product. This may involve balancing the effect of divestment on existing members of the product if needed (e.g., a fund with large unlisted allocations may need a longer period to sell those investments ahead of transferring member accounts) with the impact on members remaining in the underperforming product.

Funds that are already in the process of transferring member accounts to a product that has passed the test – either voluntarily or to comply with a licence condition that APRA has imposed – must also finalise the process within a reasonable timeframe.

This goes one step further than the existing consequences, and in our view, will better protect the interests of disengaged members in persistently underperforming products (including through incentivising underperforming funds to merge).

Setting out the consequence in the legislation – rather than relying on APRA to use its powers at its discretion – has the additional benefit of ensuring outcomes are consistent and clear.

The contrary view offered by some that the current consequences for failing the test are too harsh is in part driven by the shortcomings of the current test methodology. If the performance test was robust and accurate, there would be no sound reason for the consequences of failure to not be strict if the policy intent is to support members' best financial interests through improved fund performance.

Recommendation 1: The legislation should prescribe that a product that has failed the performance test two years in row must not accept any new members and must transfer any existing member accounts to a product that exceeds the test with reasonable timeframe.

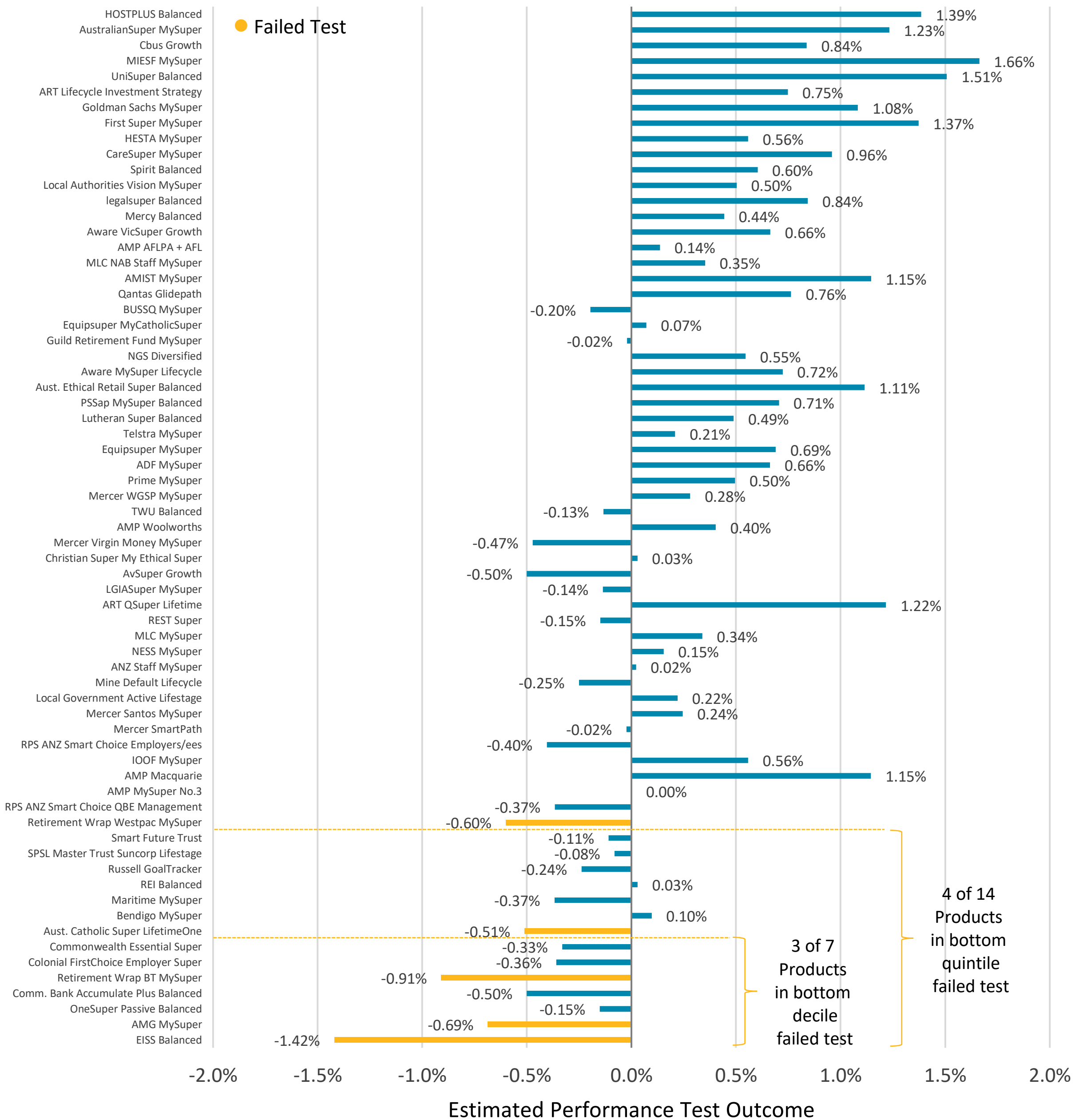
Amending performance test outcomes beyond pass and fail

There are currently two possible outcomes for products that are subject to the performance test: pass or fail. Based on the 2022 performance test results, it is clear that the vast majority of MySuper products pass the test (64 passed, 5 failed). However, this does not necessarily mean that the vast majority of MySuper products can be considered 'good' products. There is also significant performance variance between products that passed the test, which was evident in the last MySuper product heatmap (and is discussed above and shown in figure 1). We expect the next heatmap will show a similar trend.

The relationship between passing or failing the test and a product's performance is not always clear. ISA modelling shows that a number of products that passed the test achieved lower net returns than a product that failed the 2022 performance test (figure 2). The test is failing to provide members in these poor-performing products, which have nevertheless passed the test, with adequate information about performance.

A simple binary pass/fail test outcome also fails to adequately reflect the value added by trustees of top performing funds. Products in the bottom quintile that still passed the June 2022 tests returned 2.1 per cent per annum less on average over the past 8 years to their members than products in the top quartile (asset weighted).

Figure 2: ***Relationship between test outcomes and net returns***
Estimated test results ranked by net return, June 2022



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual Superannuation Performance Test – 2022, APRA Quarterly Superannuation Performance Statistics (June 2022).

Further, the failure of the test to incorporate risk means many members are in relatively risky products that deliver poor returns without evening knowing. An examination of MySuper product returns, as well as the volatility of these returns, reveals several products deliver returns that are significantly below (in some cases, more than 200 basis points below) MySuper products with an equivalent level of risk or volatility (figure 3).

Figure 3: ***MySuper product net return and volatility***
Representative member; 8 years to June 2022

Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual Superannuation Performance Test – 2022.

The way that the performance test currently operates means some members might potentially consider what is a poorly performing product to be a 'good' product. In our view, this issue will likely persist even if our recommendations around test methodology are implemented because there are only two possible test outcomes.

We also note the relevance of the Productivity Commission's recommendation about a 'best in show' shortlist and the (now abandoned) role of the Fair Work Commission Expert Panel that was set up to ensure only high-performing super funds are named as default funds in modern awards. Both of these measures were directed at identifying good products – rather than products that just pass a benchmark.

In the absence of more wholesale changes to the way in which product performance is assessed, the Government should consider whether amending the performance test outcomes – with different and proportionate consequences for each of the outcomes – will better inform and protect consumers, drive competition amongst funds and place downward pressure on fees.

For example, instead of a pass or fail outcome, there could be three possible outcomes for a product that is subject to the test:

- exceeds (where the score of the product's performance in the test is greater than 0.25%)

- pass (where the score of the product's performance in the test is between -0.5% and 0.25%)
- fail (where the score of the product's performance in the test is less than -0.5%).

There would then be proportionate consequences for products that 'pass' or 'fail' the test, with only products that 'exceed' the test not being subject to any consequences. A possible consequence for products that merely 'pass' the test could be a requirement that they notify members and let them know what the fund is doing to improve its performance.

To some extent, this would also reflect the way APRA is currently supervising fund performance. For example, APRA has advised that passing the performance test does not necessarily mean the fund is in clear water and has escaped their radar.[4]

If the outcomes of the test are updated, this should also flow through to the YourSuper comparison tool. We also note the results of surveys conducted by the Australian Taxation Office (ATO) and Behavioural Economics Team of the Australian Government about the design of the YourSuper comparison tool, which suggest that this approach (where there are three possible outcomes) can help to better inform and protect consumers.[5]

Recommendation 2: The Government should amend the performance test outcomes to reflect exceeds, pass, and fail outcomes, and apply proportionate consequences depending on the relevant outcome.

Interaction with merger discussions

The communication materials an underperforming fund issues to its members – including the letter or email required under section 60E of the *Superannuation Industry (Supervision) Act 1993* – should not mislead members about the gravity of failing the performance test.

However, in the interests of full disclosure that may assist members, failing funds that are engaged in merger activity should have the option to provide that information to members if the merger discussions are sufficiently advanced. Otherwise, members are more likely to leave the poor performing fund, which makes it a less attractive merger partner (thereby adversely affecting disengaged members in the poor performing fund).

We recognise that those merger discussions need to be sufficiently advanced so that the member can be confident that they will end up in a better performing fund within a short timeframe. In our view, it may be appropriate for funds to include this information in their letter to members only if the fund has signed a memorandum of understanding or heads of agreement document with high level agreement on the merger, with the expectation that the merger will take place in the next 12 months.

Recommendation 3: In communications to members about failing the performance test, funds should be able to include information about an agreed merger if there is a reasonable expectation that the merger will take place in the next 12 months.

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[4] Margaret Cole, *Speech to the Investment Magazine Chair Forum* (28 March 2022).
[5] Department of the Prime Minister and Cabinet and the Australian Taxation Office, *YourSuper Comparison Tool: Results from a survey and two survey experiments* (October 2022).

Product coverage

The YFYS performance testing regime was introduced to hold trustees to account for their investment performance and fees. However, as noted in the consultation paper, it only covers MySuper products, with a planned extension to cover trustee-directed products (TDPs) from 1 July 2023.

As performance test coverage currently stands, the majority of APRA regulated superannuation assets ($1.1bn or 55%) in respect to 6.3 million members are not currently subject to performance assessment.

Even if the scope is extended to TDP's it still won't cover thousands of choice options or any retirement products. ISA analysis indicates that this means around $650 billion in funds under management and 2.7 million member accounts will still sit outside the performance accountability framework provided by the test.[6]

This is problematic because it means that around one-third of the superannuation system will not be held to account. Figure 4A shows that around 33 per cent of assets will still be out of scope following the extension to TDPs in 2023, with a substantial portion of assets in the retail sector (around half) remaining outside the performance testing regime – undermining sector neutrality (figure 4B).

Figure 4A: Share of assets in and out of scope (June 2021)

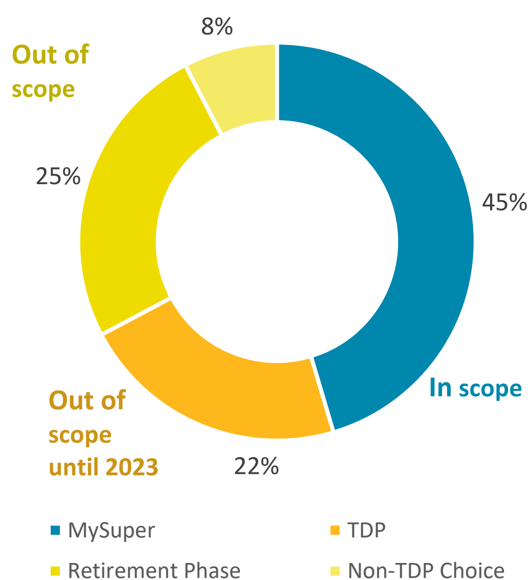
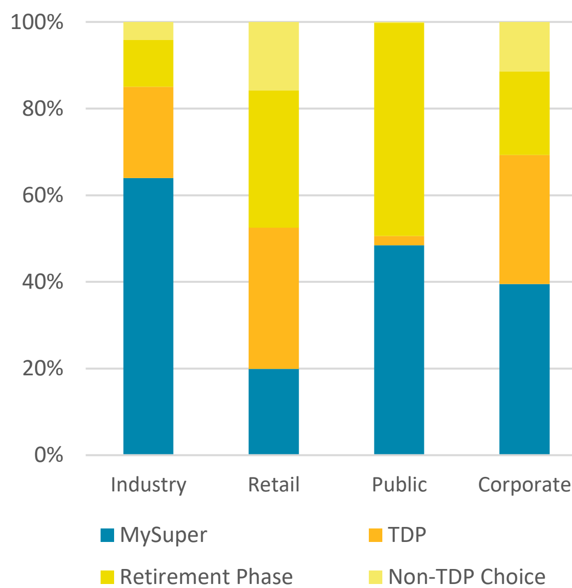


Figure 4B: Share of assets by sector (June 2021)



Source: APRA Annual fund-level superannuation statistics (June 2021), APRA Annual superannuation bulletin (June 2021), SuperRatings Fund Crediting Rate Survey (June 2021).

[6] Source: APRA Annual fund-level superannuation statistics (June 2021), APRA Annual superannuation bulletin (June 2021), SuperRatings Fund Crediting Rate Survey (June 2021).

The performance test should be extended to all APRA-regulated accumulation products

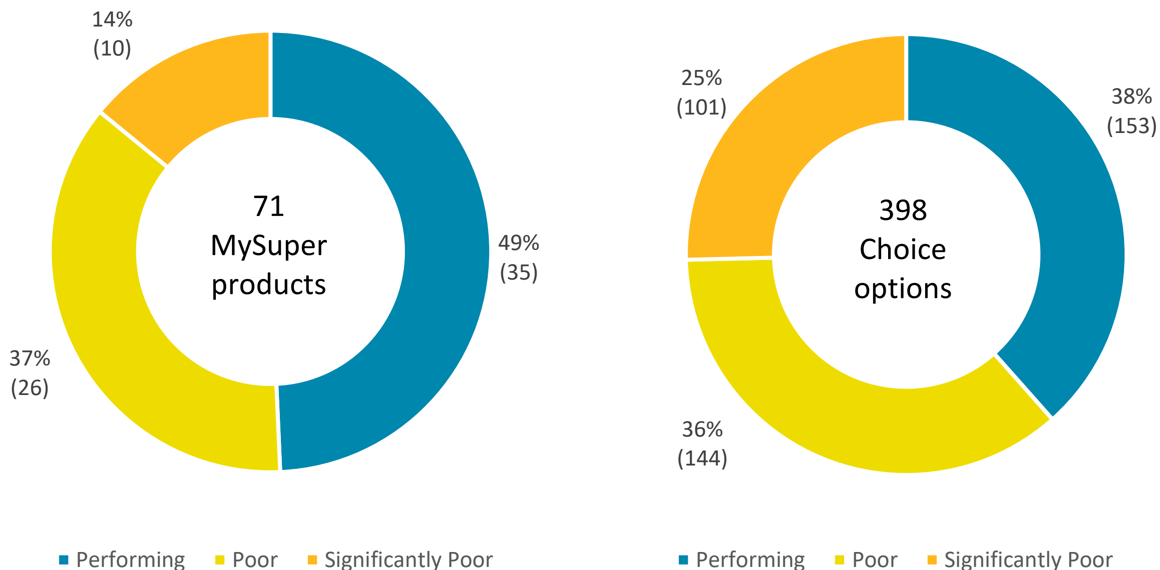
ISA's view is that in a compulsory system, all members should be connected to a high performing fund – irrespective of whether they have actively chosen the fund.

Testing all products on the market would hold all funds to the same standards of transparency and accountability, providing the same protections to all consumers and creating a level playing field for funds.

On average, the choice segment significantly underperforms in comparison to the MySuper segment (figure 5), while also charging higher fees. The most recent APRA heatmaps, which included some choice products for the first time, showed that:

- the median administration fees for choice products were 40 per cent higher than for MySuper products (based on members with a $50,000 representative balance),
- more than 60 per cent of choice investment options fell short of APRA's benchmarks over a seven-year period,
- 25 per cent had 'significantly poor returns' for their members, and
- there was significantly more performance variance across the choice sector.

Figure 5: ***The choice sector significantly underperforms the MySuper sector***
June 2021



Source: APRA MySuper and Choice Heatmaps Insights Paper (December 2021), APRA MySuper Heatmap (December 2021).

This is further compounded by the operation of the existing stapling reforms, which means that members can be unknowingly stapled to underperforming funds that are not subject to the test. The financial consequences for these members in retirement can be significant.

ASICs recently released Corporate Plan indicates that it is undertaking surveillance on superannuation trustees' distribution practices in relation to choice products that will include 'examining the role of financial advisers and their licensees in the distribution of underperforming choice products'.[7] This work further highlights acknowledgement of the risks of consumer harm from underperforming choice products.

The Productivity Commission clearly stated that trustees are ultimately responsible for the products they design and offer to members. Anticipating arguments from parts of the super sector that trustees should not be held accountable for underperformance where members make active investment choices, the Commission countered, "it is the quality of investment options being offered to members…that should be the focus of regulatory attention." 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…"

In our view, all APRA-regulated accumulation products should be subject to annual performance testing – not just MySuper products and TDPs.

It would increase overall comparability and apply the scrutiny the Productivity Commission envisaged was needed to address underperformance, which it identified, and the evidence continues to show (see figure 5 above) is mainly in the choice sector, which is subject to less scrutiny than the MySuper sector.[8]

ISA's view is that extending a performance test to choice products would be relatively straightforward given that performance would be assessed in a similar way to MySuper products. Even for multi-asset class options, the principles to be applied are no more complex.

ISA also does not support carve outs on performance testing for member-directed or single asset products. Members in these products also deserve to know how these products are performing relative to others, and a suitable performance test focused on long-term net returns could be created.

A performance test should also apply to retirement products

Since the Retirement Income Covenant commenced on 1 July 2022, trustees have been required to develop a retirement income strategy for retired members or those approaching retirement.

As noted by APRA and ASIC, the covenant was an important step in broadening industry focus beyond the accumulation phase to the decumulation phase of superannuation, and in encouraging innovation to improve members' retirement outcomes.[9]

It is expected that under the covenant, funds will develop and offer new retirement products for their members. With a wider range of options, it will be more important that members have access to clear and simple information that helps them differentiate between good and poor performing retirement products.

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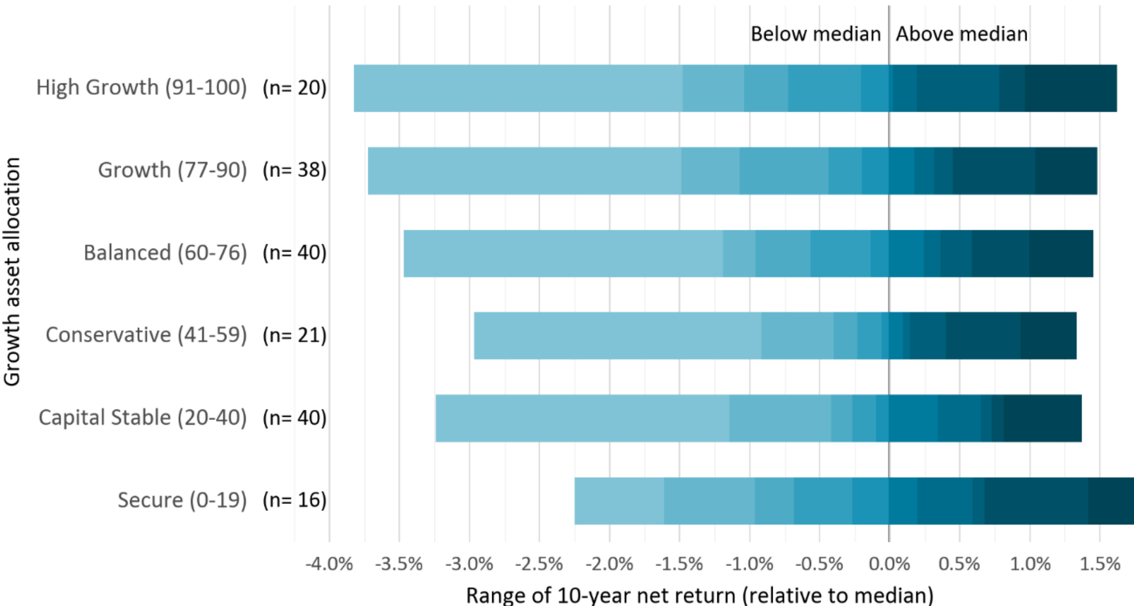
[7] ASIC, *Corporate Plan 2022-26* (August 2022), 10.
[8] Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness Inquiry Report* (21 December 2018).
[9] APRA and ASIC, *Letter to RSE Licensees: Implementation of the Retirement Income Covenant* (7 March 2022).

Recent research by the ARC Centre of Excellence in Population Ageing Research also shows that financial mistakes – such as choosing an inappropriate retirement product – are more likely and more consequential when ageing, complexity, and large sums of money combine.[10]

Therefore, applying the performance test to retirement products will provide valuable information for members (including helping to minimise the risk of financial mistakes occurring) and hold trustees accountable for the products they offer.

The evidence shows there are substantial differences between the performance of pension products, which further highlights the importance of subjecting these products to a performance test.
For example, the top 10 per cent of balanced options returned 2.8 per cent per annum more than the bottom 10 per cent of options over the past 10 years, and the worst performing balanced option had a return 4.9 per cent per annum less for its members than the top 10 per cent of funds over this period (figure 6).

Figure 6 ***Distribution of 10-year net returns around the median***
By growth asset allocation category, June 2021



Source: SuperRatings Pension Fund Crediting Rate Survey (June 2021).

The substantial variances in the performance of pension products have a significant impact on member outcomes. A member aged 65 years old now who retires with superannuation of $200,000 and draws down on assets at a rate of 10 per cent per annum, would have superannuation fund earnings of almost $80,000 more during their retirement if they were invested in a top decile product rather than a bottom

[10] ARC Centre of Excellence in Population Ageing Research, *Financial decision making for and in old age* (October 2022).

decile product.[11] This not only has a significant impact on retirement incomes, but also saves future taxpayers via a reduction in age pension expenditure.

ISA’s view is that it would not be difficult to extend a performance test to account-based pensions, which currently comprise most of the market for retirement income products. The investment approach for these products is similar to accumulation products, and long-term investment performance remains crucial to good member outcomes. Although levels of investment risk and income stability become more relevant in the retirement phase, their importance should not be over-emphasised and these considerations do not pose a barrier to performance testing.

We support extending the performance test to account-based pensions first, while further work is done to formulate a test for other retirement income products.

Recommendation 4: All APRA-regulated superannuation products (other than defined benefit products) and retirement income products should be subject to performance benchmarking.

[11] The cameo for an individual aged 65 in 2022 who lives to average life expectancy of 87 years. In both cases they invest $200,000 in an account-based pension and drawdown on assets at a rate of 10 per cent per annum. The cameo compares outcomes of investing a high-quality product returning 2.82 per cent per annum more than a low-quality product.

YourSuper comparison tool

ISA supports the intent of the YourSuper comparison tool, particularly given its potential to help consumers who are interested in engaging with their super. Our recommendations below aim to ensure:

- consumers are not misled by the tool, and
- the tool contains important information needed by a consumer to properly compare superannuation products.

Consumer testing of the tool

We understand the ATO did not undertake any consumer testing of the tool before it was launched.[12] Instead, in developing the tool, it appears the ATO looked at nine other comparison tools/websites to understand industry standards and key features offered and undertook user testing with 20 individuals in the early design phase of the tool. It also appears that together with the Behavioural Economics Team of the Australian Government, the ATO conducted a survey and survey experiments, narrowly focusing on how users may respond to specific design options e.g., how to communicate the risk/return trade-off associated with different products.

It is now clear that this approach was inadequate. Anecdotal evidence suggests:

- the current tool does not have a consumer-friendly interface and is therefore not intuitive to use,
- users are confused by the way lifecycle products are displayed, and
- users consider that it would be more helpful if the age and super balance tailors are automatically displayed when using the non-personalised version of the tool, rather than being hidden by the filter button.

Therefore, the tool – and any changes to the tool arising out of this review – should be subject to rigorous and comprehensive consumer testing. This testing should cover the inclusion of a metric that allows for a monetary comparison to be made between products, based on performance test scores or similar. In our view, this will help users to better understand the value added or lost by the products assessed.

Recommendation 5: The tool should be subject to rigorous and comprehensive consumer testing. This testing should cover the inclusion of a metric that allows for a monetary comparison to be made between products, based on performance test scores.

Default sorting method

As noted in the consultation paper, the YourSuper comparison tool sorts MySuper products from lowest to highest annual fees by default. In our view, this approach is flawed and when combined with a binary ‘performing’ or ‘underperforming’ measure, is also misleading.

[12] ATO, *Answers to questions on notice at Senate Estimates on 1 April 2021* (7 May 2021).

ISA has long supported the use of long-term net returns as the metric to assess and compare super products. Net returns take into account administration fees, investment fees, advice fees and costs and taxes, and are therefore an accurate reflection of the actual returns that members receive in their accounts. The return period used should be the longest time period possible to account for risk and market cycles.

While fees are an important consideration for consumers, they are only one piece of the puzzle. The correlation between fees and net returns is weak (see figure 7A), while there is virtually no correlation between the default rankings of the YourSuper Comparison tool and long-term net return rankings (see figure 7B).

The default sorting method currently results in Colonial First State's FirstChoice Employer MySuper product receiving top-billing, when in fact:

- this product is ranked 62nd out of 67 MySuper products in terms of long-term net returns,
- its average annual net return over the past 8-years is some 300 basis points below the market leader in Hostplus's Balanced option, and
- it failed the performance test in 2021.

Likewise, Australian Retirement Trust's QSuper Lifetime is ranked second by default but has only the 39th highest net return over the past 8-years, averaging around 230 basis points per annum below Hostplus's Balanced option.

Ultimately, it is net returns that matters to consumers. It would be more useful for consumers if products are sorted based on net returns by default (from highest net returns to lowest). We also note that annual fees for a product can be highly variable depending on the user's age and super balance. Therefore, another benefit of using the net returns metric as the default sorting method is that it is comparatively stable.

For lifecycle products, net returns should be shown as a single product level return (asset weighted by life stage). A range is confusing for users and contrary to the way the performance test is applied.

Figure 7A: Total fees vs net returns, June 2022

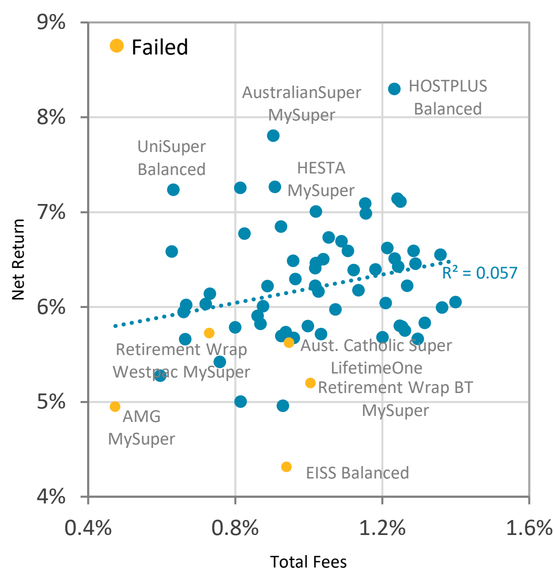


Figure 7B: Default sorting vs net return rank

Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual Superannuation Performance Test – 2022, ATO YourSuper Comparison Tool (June 2022).
Note: Total fees are expressed as percentages of representative member balances of $50,000.

Recommendation 6: The tool should by default, sort products from highest long-term net returns to lowest long-term net returns. For lifecycle products, net returns should be shown as a single product level return (asset weighted by life stage).

Outcomes of the performance test

Earlier in this submission, we discuss the flaws of the current performance test and recommend that the Government consider proportionate responses for products that are linked to graduated outcomes (Recommendation 2).

Consistent with that recommendation, consumers will receive a more accurate understanding of the performance of a product and how it compares to other products if the investment performance column of the tool reflects these graduated outcomes and allows for products to be ranked by their performance test score. A binary test outcome combined with current default sorting by fees leads to a perverse and misleading outcome by which products that barely pass the test but have the lowest fees are ranked ahead of products with the highest test scores.

Recommendation 7: The tool should show whether the product exceeds, passes, or fails the performance test and should allow products to be ranked by their test score.

Inclusion of insurance in the tool

Life and TPD insurance offered through super can be a significant consideration for members – particularly if they work in a dangerous occupation, are older or have dependents.

Therefore, the YourSuper comparison tool should include information that shows users either:

- the cost of default insurance premiums against the default cover provided, or
- the default level of cover (in dollars).

This will help users to broadly compare default insurance offered through various super products. If either approach is adopted, the tool should also make clear that:

- factors such as the person's age, gender and occupation type are likely to affect their premiums and cover, and
- the default insurance provided by funds generally differ in terms of cover (e.g., exclusions and waiting periods).

We note APRA currently publishes the cost of insurance premiums per $1,000 of default cover in their quarterly MySuper statistics and are working on a new publication that will make it easier to compare insurance offerings as part of its Superannuation Data Transformation project. This work – alongside rigorous consumer testing – should inform the inclusion of insurance in the tool.

The tool should also let users know whether default insurance is provided to members working in dangerous occupations who are under 25 years of age or have an account balance below $6,000 (i.e., if the product has a dangerous occupation exception from the Putting Members' Interests First legislation). This information could be provided when the user shortlists products for a detailed comparison and has indicated through the filters that they are under 25 years of age or have an account balance below $6,000.

Additionally, given the purpose of the tool is to allow users to compare and choose a super fund that meets their needs, there should be a warning to users that switching funds is likely to result in the loss of any insurance the member may have with their existing fund, and they may not be able to get the same cover with a new fund. We note for example that Moneysmart prompts members to check their insurance cover before consolidating their super.[13] A similar warning for users in the comparison tool will help inform them of the potential insurance risks associated with switching funds.

Recommendation 8: The tool should include information about either the cost of default insurance premiums against the cover provided or the default level of cover. The tool should also let users know whether the product has adopted the dangerous occupation exemption under the Putting Members' Interests First legislation.

[13] Moneysmart, *Consolidating super funds* (accessed 14 October 2022).

Interaction with product dashboards

In our view, it is useful to provide links to the product's MySuper product dashboard when the user shortlists those products for a more detailed comparison. In particular, it can help consumers who are seeking information that is not included in YourSuper comparison tool, such as information about the level of investment risk or the return target.

However, there is also overlapping and inconsistent information provided in the tool and the product dashboard. For example, the annual fees that are listed in the YourSuper comparison tool are different to the statement of fees and other costs listed in the Product Dashboard. It is also unclear why the return periods used are so inconsistent. In our view, a better approach would be if the longest return period in the tool lines up with the longest return period in the dashboard – that is, 10 years.

Recommendation 9: Inconsistencies between the tool and the product dashboards should be minimised to reduce the risk of confusion for members.

Limitations of the tool

To minimise the risk of members making poor decisions based on the tool, the limitations of the tool could be more clearly set out.

For example, when the user shortlists products, text above the information about the shortlisted products about insurance merely indicates that funds must offer MySuper members death and TPD insurance and may choose to offer income protection insurance. This is entirely insufficient, as it does not actually make clear that the tool does not compare insurance and that insurance can be an important consideration for members. Of course, if our recommendation above regarding the inclusion of insurance in the tool is implemented in full, this issue may be less concerning.

It should also be made clear that the tool does not take into account asset allocation or investment risk. In our view, the tool should expressly point to the Product Dashboards for further information on these topics. While we note this information could be incorporated into the tool, on balance, we think doing so will risk the tool becoming less simple and navigable for consumers.

Recommendation 10: The limitations of the tool should be set out more clearly.

Extension of the comparison tool to choice products

Consistent with our submission above about extending the performance test to choice products, we strongly support the extension of the comparison tool to choice products, once they are subject to the test.

On average, the choice segment significantly underperforms in comparison to the MySuper segment while also charging higher fees on average (further information is set out in the section above on performance test product coverage).

Our analysis shows that as at 30 June 2021, choice products account for around 48 per cent of funds under management and 29 per cent of member accounts of APRA-regulated superannuation entities

with more than four members.[14] This is a significant segment of the superannuation industry which is not captured by the comparison tool.

While the heatmaps provide much-needed transparency into the choice sector, they are not designed for consumers to use. Therefore, extending the comparison tool to the choice sector would allow the millions of members of choice products (or prospective members) to be able to see simple comparisons around net returns and fees.

This extension should also be supplemented with the commencement of the choice product dashboards regime, which we note has already been deferred for eight years. This will support more informed decision-making by consumers, which can drive competition and place downward pressure on fees. Failure to do so will also result in an uneven playing field that entrenches lack of product neutrality and in turn, sector neutrality.[15]

In terms of implementation, we understand that there may be some concerns about overloading consumers with information if choice products are to be included in the same tool as MySuper products. However, in our view, the benefits of doing so for consumers outweigh the risk.

There are also design considerations that can mitigate this risk to an extent. For example, the Government could consider whether the default position should be that choice products are filtered out, with the option of being filtered into the tool (either on their own or alongside MySuper products). This could avoid overwhelming consumers who are only interested in MySuper products, while still ensuring that consumers who are interested in choice products (including because they have a choice product) can compare the product against other choice products, and also against MySuper products.

Recommendation 11: The comparison tool should be extended to include choice products and the choice product dashboard regime should commence.

A comparison tool for retirement products

Consistent with our submission above about extending the performance test to retirement products, we support the development of a comparison tool for retirement products, once they are subject to the test. If account-based pensions are subject to the performance test first, the tool should similarly cover these products as a starting point.

This will help ensure consumers have accurate and impartial information to help them find an appropriate retirement product, or to determine whether they are in a good or poor performing product. Given members are making minimal or no contributions to their super, it is arguably more important that retirement products perform well for members.

This also recognises that it is impossible for all members who are either approaching retirement or retired to obtain quality personal advice about the appropriate retirement product for them. It is also unclear at this stage how the retirement income covenant will play out in terms of connecting members

[14] Source: APRA Annual fund-level superannuation statistics (June 2021), APRA Annual superannuation bulletin (June 2021), SuperRatings Fund Crediting Rate Survey (June 2021).
[15] Our analysis of APRA data shows that in June 2021, 79 per cent of funds under management in the retail sector were in choice products and 35 per cent of funds under management in the industry sector were in choice products. Ibid.

with good retirement products, although it is expected that funds will develop more retirement products under their respective strategy. Accordingly, a simple comparison tool that covers retirement products would be valuable for members.

In terms of implementation, we support a separate tool being developed for retirement products. Separating retirement and accumulation products is preferable given they have different objectives, and this approach will minimise the risk of confusing users.

Recommendation 12: A comparison tool should be developed for retirement products.

Stapling

A better stapling model

ISA has long supported a stapling model that is based on the automatic rollover of balances. Under this model, each member is stapled to their balance which is automatically rolled over into their new account when they join a new employer, unless they exercise choice. Only those products that have been periodically approved by an expert panel within the Fair Work Commission would be permitted to be used for default purposes in awards or enterprise agreements.

This model would improve outcomes for members by addressing many of the issues with the existing stapling model, including inadequate insurance coverage for employees in dangerous occupations, members being stapled to underperforming funds, and the administrative burden/complexity for employers in complying with the requirements. It also affords the additional benefit in that the prevalence of existing members with multiple accounts could be addressed through an ongoing auto-consolidation process.

Analysis by KPMG undertaken for ISA indicates that implementing this model will reduce fees and insurance premiums leading to an estimated saving of $9 billion over 25 years, and improved returns from positively connecting members to high quality products of $133.2 billion over 10 years.[16]

More generally, the existing stapling model ignores the benefits of the default system, which has served Australians well for decades. The default system has seen many members land in high performing funds, with appropriate insurance cover that is tailored to their working circumstances and life trajectory.

Recommendation 13: The Government should transition the current stapling model to one that is based on the automatic rollover and consolidation of balances in instances where member do not actively choose a fund.

The first steps in transitioning the stapling model are set out in our next two recommendations.

Members should not be stapled to underperforming or untested products

The stated intent of the stapling reforms is to minimise the erosion of retirement savings by preventing the creation of unintended multiple superannuation accounts when disengaged members change jobs.[17]

In our view, this intent cannot be achieved if members can be stapled to an underperforming or untested product. Coupled with the carveouts from performance testing for some choice products, some members will never be informed they are in and stapled to an underperforming product. This consequence is perverse and completely at odds with the objective of the reform.

Our modelling shows that being stapled to a poor-performing product could cost a member as much as $230,000 at retirement (figure 8).

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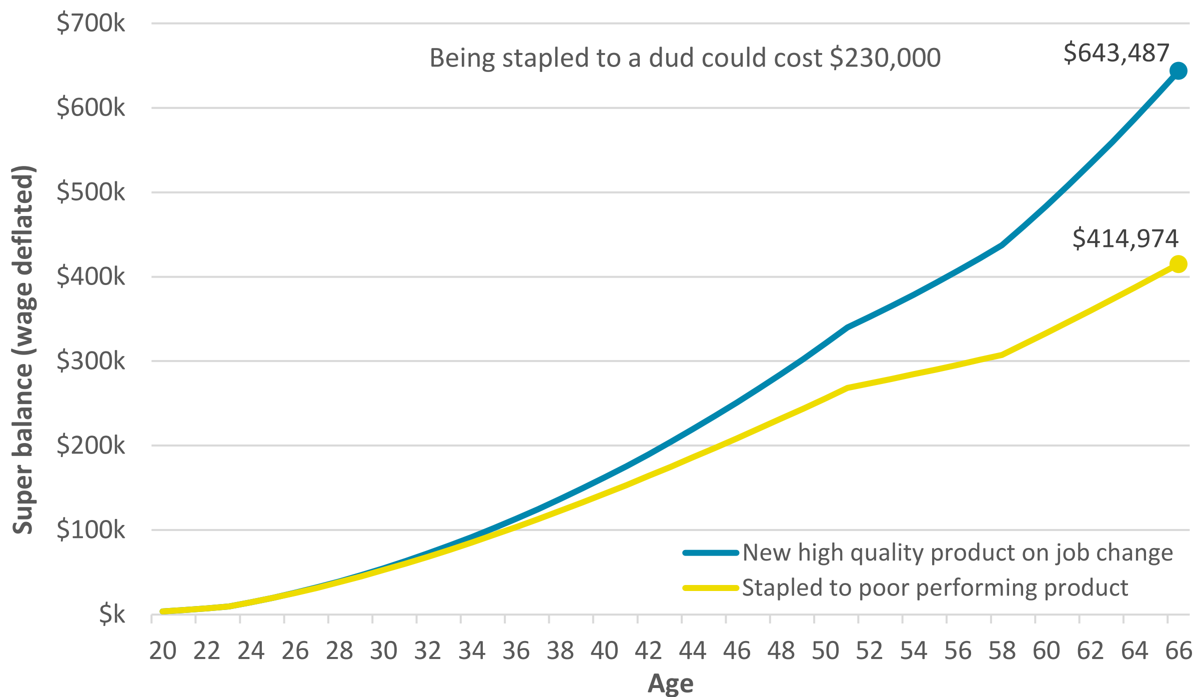
[16] KPMG, *Stapling of superannuation accounts* (3 July 2019).

[17] Explanatory Memorandum to the Treasury Laws Amendment (Your Future, Your Super) Bill 2021, 5.

Figure 8: ISA analysis of the costs of being stapled to a poor performing fund



Notes: The cameo is for a person commencing work at age 20 in an underperforming MySuper fund and who changes jobs at 23. They are assumed to earn the age-based median income while working. The cameo assumes half SG-coverage between the ages of 20 to 23 and no SG coverage (e.g., business income) between the ages of 52 to 58, leaving 38 years of SG coverage over their working life. If they remain stapled to the underperforming fund, they are projected to have $228,513 less in retirement savings compared with switching to a fund that passes the performance benchmarks. The average risk adjusted net return difference is 1.79% p.a. All figures are wage deflated to current dollars.

If our recommendations about tougher consequences for products that have failed the performance test twice and for all choice products to be tested are accepted by the Government, we note this becomes less of an issue. However, we support members not being stapled to a product that has failed the test once (and that failure relates to the most recent test). In our view, this will better protect consumers while also further encouraging funds to improve their performance.

Recommendation 14: The meaning of “stapled funds” in section 17A of the *Superannuation Guarantee (Administration) Regulations 2018* should be amended so that in addition to the existing rules, a fund can only be a stapled fund for an employee if the employee’s interest in the product offered by the fund has passed the most recent performance test. If the relevant product has not been tested (because for example, it has less than five years of investment history or because it is a choice product), the fund cannot be the stapled fund for the employee.

Impact of stapling on insurance coverage

The existing stapling model presents a significant risk for members moving into either a dangerous occupation (such as construction, transport, or emergency services) or a dangerous work activity (such as working with heavy machinery).

For these members, being stapled to an existing fund – rather than defaulted into the employer-nominated fund – can result in them retaining an insurance policy that is less likely to cover them for death or TPD, should a claim need to be made. Members who are young or have low balances are even more unlikely to have any default insurance.

The importance of default insurance through super for members working in dangerous occupations was recognised by the Government during the development of the Putting Members' Interests First legislation, resulting in the dangerous occupation exception. Under that exception, between 1 April 2020 and 31 August 2022, one of our funds has:

- paid a total of $36.6 million in insurance claims to members or their families, and
- of that amount, over $11.8 million has been paid to members who are teenagers or in their 20s.

Without the dangerous occupation exception, these members (or their families) would have received no insurance benefit at all. This shows the exception is working as intended.

While it is difficult to accurately assess the impact of stapling in this context, it is clear that without a similar exception in the stapling reforms, there is a significant risk that members working in a dangerous occupation or undertaking a dangerous work activity will not be (and have not been) covered by their default insurance in super when they need it. The risk is even higher for those members who are young or have low balances, as their stapled fund may not have adopted the dangerous occupation exception.

In our view, this will continue to be an issue for as long as there are exclusions based on a member's occupation or work activities in default insurance offered through super. Our research indicates these exclusions continue to persist.

Furthermore, default insurance offered through super that is specifically tailored for members in dangerous occupations can include other key features that are less likely to be found in more general default insurance policies. This includes for example, no waiting period for death by suicide, which is extremely rare.

Recommendation 15: Members in dangerous occupations or undertaking dangerous work activities should be excluded from the stapling reforms.

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. The recent addition of the word 'financial' to the trustee covenant does not import a duty that previously did not exist. What is new are the imprecise obligations around processes for trustees in meeting the obligation.

If the intent behind the recent reforms was to improve accountability and member outcomes, the experience of funds in implementing the reforms shows there have been unintended consequences and the duty is not always meeting its objective. Our recommendations below about applying a materiality threshold to the relevant record keeping obligations and providing related guidance aim to mitigate these issues, while still ensuring that small or immaterial expenses remain subject to the BFID and the sole purpose test.

The consultation paper states it is important to clarify whether the BFID measures and regulatory changes are improving compliance practices in the superannuation industry. ISA suggests that the focus should instead be on whether the BFID is working to ensure trustees are acting in the best financial interests of members and improving member's financial outcomes, given that is the policy intent of the regime.[18] As the Productivity Commission stated, members' outcomes — more than process or intent — must be the key focus of governance arrangements and trustee endeavour.[19]

Costs

A stated policy objective of the BFID was to deliver financial benefits to members. Treasury estimated a financial benefit accruing to members of $1.1 billion over 10 years as a result of the best financial interests duty, based on a reduction in administration expenses.[20]

However, when the BFID was introduced, ISA foreshadowed that the government's approach to enforcing this obligation – a reversed evidentiary burden and no materiality threshold – would come at an additional cost to members with no demonstrated additional benefit. Implementation of the reforms suggests this has been borne out in practice.

Given the presumption that all expenditure, no matter how immaterial, is not in the best financial interests of members, trustees have had to establish business systems and record keeping processes to ensure they are able to meet their statutory obligation to demonstrate that any expenditure or investment decision was reasonably made in the best financial interests of members.

The BFID has consequently materially increased expenditure by funds on internal and external activities to support compliance with the obligation – the benefits of which are often not clear. For example, some funds observed:

- that implementing the BFID has significantly increased compliance costs without resulting in a material change to their expenditure decisions,

[18] Explanatory Memorandum to the Treasury Laws Amendment (Your Future, Your Super) Bill 2021, 36.
[19] Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness Inquiry Report* (21 December 2018), 421.
[20] Treasury, *Answers to questions at Senate Estimates on 26 October 2020*.

- the cost of justifying the expenditure can outweigh the expenditure, and
- delaying or not making expenditures that would have benefitted members because the time, effort or difficulty involved in justifying the expenditure is too great.

Ultimately all expenses and opportunity costs are borne by members.

ISA commissioned Accenture to review the operation of the BFID among some of our funds and quantify the cost of compliance. The review shows that Treasury's estimates about the financial benefits for members under the BFID have failed to materialise, with the reform instead adding to the administrative cost base for funds. In particular, the analysis shows that BFID obligations are estimated to cost all industry super funds around $11-15 million each year.

- Complying with BFID cost funds between $752,000 and $1.3 million initially, with an estimated $478,000 to $670,000 in ongoing costs.
- Over 10 years, complying with BFID will directly cost industry fund members between $82 million and $115 million. If the opportunity costs of lost investment opportunities were also considered, the cost to industry fund members would be substantially higher.[21]
- BFID compliance costs are highly dependent on the number of expenses recorded and requests from APRA, which are a function of fund size, interpretation, and risk-appetite.
    - Larger funds had more expenditure outflows and members, which increased the number of expenditures recorded.
    - Funds that interpreted reporting at a more granular level had to prepare, generate, and record more expenditure activity, instead of aggregating expenditure into higher-level categories.
    - More risk-averse funds were highly likely to record more expenditure and do so at a more granular level.
- The biggest cost driver across all industry funds was ongoing, day-to-day expenses which totalled $504,000 in the first year, accounting for approximately 40 per cent of overall initial costs.

The cost framework and cost assumptions used by Accenture are in **Annexure A** to this submission.

Without clear guidance, funds have been obliged to implement processes that have been over-engineered out of an abundance of caution. A materiality threshold and guidance around record keeping is needed to minimise inefficiencies and avoidable adverse member outcomes.

Materiality threshold

The absence of a materiality threshold means it is arguably an offence for trustees to make any expenditure – however small or immaterial – without undertaking a robust process, including

[21] The $82-$115 million costing represents direct costs over 10 years with a discount rate applied across all 31 industry funds. Indirect costs such as opportunity costs have not been quantified due to their inherent uncertainty, but they represent a real and substantial additional cost for industry fund members.

appropriate record-keeping to meet the obligation to demonstrate that the expenditure will yield quantifiable financial benefit to members.

ISA's view is that a materiality threshold would improve member outcomes by helping to reduce significant unnecessary compliance costs and focus efforts away from unproductive compliance activity with minimal to no member benefits. Expenses under the materiality threshold must still be in members' best financial interests and meet the sole purpose test – consistent with the objective of lowering costs for members, putting downward pressure on fees, and therefore improving financial outcomes.

Accenture analysis shows that a materiality threshold could save all industry funds between $21 million and $35 million over 10 years.[22]

There are a number of possible approaches to setting a materiality threshold.

- Applying a percentage of fund assets or a percentage within an expense group. This approach was initially used by APRA in Reporting Standard SRS 332.0.[23]
- Applying a minimum monetary threshold. However, in our view, this approach has some risk. It would be difficult to craft appropriate safeguards to ensure expenditure is not deliberately packaged to circumvent the BFID. Further, a flat monetary figure does not take into account the relative scale of a fund.

APRA's prudential standard on outsourcing arrangements offers a potentially useful way of considering materiality in the context of the BFID.[24]

The materiality of an outsourced activity, for which additional managing and monitoring activity applies, is one that one that has the potential, if disrupted, to have a significant impact on the APRA-regulated institution's or group's business operations or its ability to manage risks effectively. This assessment must have regard to factors such as:

- the financial and operational impact and impact on reputation of a failure of the service provider to perform over a given period of time,
- the cost of the outsourcing arrangement as a share of total costs,
- the degree of difficulty, including the time taken, in finding an alternative service provider or bringing the business activity in-house,
- the ability of the APRA-regulated institution or member of the group to meet regulatory requirements if there are problems with the service provider,
- potential losses to the APRA-regulated institution's or group's customers and other affected parties in the event of a service provider failure, and

[22] Annexure A.

[23] *Financial Sector (Collection of Data) (reporting standard) determination No. 15 of 2021* (Reporting Standard SRS 332.0 Expenses).

[24] *Banking, Insurance and Life Insurance (prudential standard) determination No. 6 of 2016* (Prudential Standard CPS 231 Outsourcing).

- affiliation or other relationship between the APRA-regulated institution or group and the service provider.

On balance, ISA's preferred view is to avoid a percentage or dollar amount but to adopt a principles-based definition of materiality.

This is a complex area and if the Government decides to introduce a materiality threshold, there should be further consultation on the most appropriate approach.

> **Recommendation 16:** The Government should apply a materiality threshold to the additional record keeping obligations.

Additional guidance on record keeping

The absence of meaningful guidance on what records funds should keep to demonstrate expenditure is in members' best financial interests is resulting in confusion, inconsistency in approaches between funds and, in many cases, over-engineering of processes resulting in avoidable costs. Accenture analysis shows a materiality threshold together with guidance on reporting could save all industry funds between $27 million and $43 million over 10 years.[25]

While we accept that funds can and do seek advice on how to justify expenditure and maintain appropriate records, given the duty applies to every expenditure made by a fund, it is highly inefficient for the regulators to not provide clear guidance on their expectations of funds when administering the law.[26]

> **Recommendation 17:** APRA should provide clear guidance on how expenses should be justified and what records should be kept.

Misdirected focus

When the BFID was introduced, ISA raised concerns that the focus of the law was misdirected. The law 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 Explanatory Memorandum to the Bill also distinguishes between expenditure that is 'essential' to the prudent operation of a superannuation entity and 'discretionary or non-essential' expenditure and applies different standards for determining whether the expenditure is in members' best financial interests.[27]

In both cases, the law effectively ignores significant costs that have been shown to have a material effect on member outcomes.

Essential versus discretionary expenditure

The Explanatory Memorandum to the Bill states that essential expenditure is likely to be regarded as in members' best financial interests if it is competitively priced and continues to achieve its intended

[25] Annexure A.
[26] We note that APRA has provided some guidance in its information paper on findings from their thematic review of RSE licensee expenditure dated October 2021, however, the guidance is limited and focused on marketing expenditure.
[27] Explanatory Memorandum to the Treasury Laws Amendment (Your Future, Your Super) Bill 2021, 41.

outcomes, but discretionary expenditure must be justified by a business case supported by analysis and quantifiable metrics to reflect expected financial outcomes. In other words, there is a significantly greater level of scrutiny for discretionary expenditure.

The meaning of essential expenditure in the explanatory materials captures some high-expense items that have a greater potential effect on member outcomes, such as investment management and administration expenses. The Productivity Commission report shows that these expenses – which are often made to related parties among retail funds – are one of the largest components of total expenses and account for a greater proportion of poor member returns.[28] Yet based on the explanatory materials, they are interpreted as being subject to a lower standard of scrutiny compared to discretionary expenditure.

Consistent with the approach outlined in the explanatory materials, APRA's compliance activities also appear to be unduly focused on areas considered to be discretionary, such as marketing and sponsorship expenditure at the expense of areas of greater risk to members' financial outcomes.[29]

A neutral and risk-based regulatory approach would focus on identifying areas of greatest potential harm to members, rather than focusing on whether the expenditure can be characterised as essential or discretionary. We note for example that service contracts and outsourcing arrangements represent annual expenditure more than 100 times that of marketing and sponsorship, yet appear to have received less regulatory attention.[30]

Recommendation 18: The level of scrutiny should be proportionate to the scale of the expenditure and the impact on member outcomes.

Related party transactions

The Productivity Commission and Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry identified significant problems with how corporate groups were using related party transactions at the expense of members' best interests.[31]

The Productivity Commission stated that:

> 'Evidence abounds of excessive and unwarranted fees in the super system – a particular focus of evidence to the Royal Commission. Because super funds are legally obliged to act in members' best interests, the fees they charge should not exceed cost recovery levels'.[32]

[28] Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness Inquiry Report* (21 December 2018), 158, 169, 172-3, 350.
[29] APRA, *Information Paper: Findings from APRA's superannuation thematic reviews* (October 2021).
[30] For FY2019: Nielsen data show $67.5 million marketing expenditure for the superannuation category, all funds; APRA Annual Superannuation Bulletin data for 2018-19 show service provider expenditure of $7.7 billion across entities with more than four members. $7.7 billion/$67.5 million = 114 times.
[31] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report: Volume 2* (4 February 2019) 101, 154.
[32] Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness Inquiry Report* (21 December 2018), 40.

In the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Report, Commissioner Hayne noted:

> 'The essential character of the conflict that confronts the trustee of any fund established for the profit of its parent company or corporate group is the conflict between the commercial interest of the parent company – to maximise profit – and the trustee's obligation to give priority to the duties to, and interests of, the beneficiaries.'[33]

We note APRA has recently released work on how trustees can improve management of outsourcing arrangements.[34] While the commentary is high-level, the work highlights shortcomings in benchmarking the value of services provided by related parties, noting that 'A common pitfall APRA observed was for benchmarking exercises to focus on justifying existing costs and service standards, rather than seeking to challenge the status quo.'

Regulators, government and those interested in improving the efficiency of the superannuation system have long been aware of the evidence that funds who operate in the for-profit sector have underperformed, and that a measurable component of this underperformance is due to the diversion of funds from member accounts to related entities with the ultimate aim of enriching those who are not members of the relevant funds.[35]

This diversion can be direct through the payment of dividends from the assets of the fund or, as is more common, diverted indirectly through the payment of fees by the fund to related parties where the cost is beyond cost recovery. The related party may declare the dividend for shareholders or again enter a commercial arrangement with another related party that ultimately results in the declaration of a dividend to shareholders or the retention of value within the group. [36]

Compared with industry funds, retail funds spend a much greater proportion of their expenses on external providers with which they have an association. Figure 9 shows that, while industry funds spent around 15 per cent of their expenses on associated external providers (i.e., related party service providers) between June 2014 to 2019, in some years retail funds spent over 55 per cent of their expenses on related party providers.

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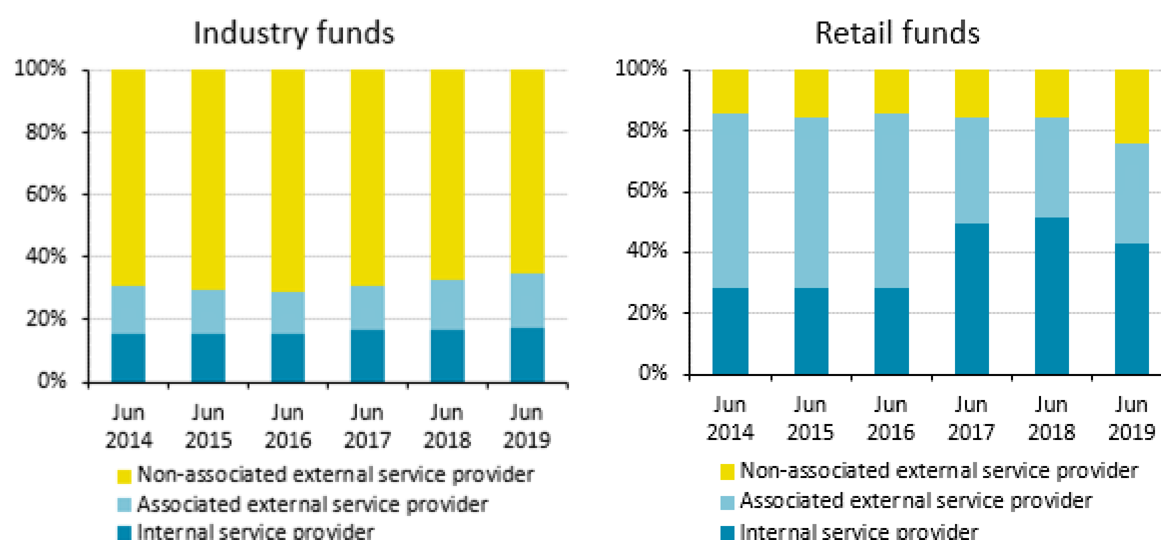
[33] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report: Volume 1* (4 February 2019) 230.

[34] APRA, *How super trustees can improve management of outsourcing arrangements* (5 October 2022).

[35] Kevin Liu and Elizabeth Ooi, *The Impact of Related-Party Outsourcing and Trustee Director Affiliation of Investment Performance of Superannuation Funds* (February 2018).

[36] Financial arrangements between a RSE and a related entity may in certain circumstances provide a benefit that is capable of being transferred to members. An example of this is reduced interest rates or fees on banking services provided to RSE's by financial institutions part of the same corporate group. The Royal Commission's findings were that the transfer of value was out of, rather than to, the RSE and its members.

Figure 9: Share of service provider expenses, 2014 to 2019



Source: ISA Analysis, APRA Annual Superannuation Bulletin June 2019.

Unfortunately, the BFID measures do not focus on the financial arrangements which the Productivity Commission has estimated to be a $10 billion a year diversion from member accounts to dividends to related parties.[37]

This situation was considered extensively in the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry 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.

Studies show that the for-profit retail sector's reliance on related party outsourcing is detrimental to fund members' investment performance.[38] Related-party service providers charge higher fees than unrelated service providers, and there is no evidence that this is justified by superior performance. Retail funds that are part of a conglomerate group are likely to be subject to more severe conflicts of interest and duties – a trade-off between duties to shareholders and fund members – which leads to more significant underperformance.

Dividend payments by retail funds to related parties were also the subject of a recent thematic surveillance by APRA, underscoring its importance to member outcomes. However, APRA has stated that it will not be publishing the results given it considers dividend payments beyond its remit.[39]

In addition, Treasury's Your Future, Your Super policy document relies on material obtained through the Financial Services Royal Commission highlighting the issue between profit and the interests of members

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[37] Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness Inquiry Report* (21 December 2018), 158, 169, 172-3, 350.
[38] Kevin Liu and Elizabeth Ooi, *The Impact of Related-Party Outsourcing and Trustee Director Affiliation of Investment Performance of Superannuation Funds* (February 2018).
[39] APRA, *Answers to questions at Senate Estimates on 6 April 2022*.

to support the intent of and rationale for the BFID reforms.[40] Yet the reforms fail to provide any transparency around this issue. Indeed, APRA considers the extraction of profit from member assets at the expense of members' financial interests to be outside its regulatory jurisdiction and exempt from the BFID (see above).

The BFID obligation fails to focus on the key expenditures made by some trustees that are unlikely to be in the best financial interests of members. It is important to note that many of these payments to related entities are for significant or core expenditures such as investment management and administration fees. All expenditures made by trustees should be with the genuine and considered belief that the financial interests of fund members will improved by the expenditure and that the expenditure outcome is considered a preferable outcome for members above other available options.

Members also deserve and want transparency around the extraction of profit and divided payments. Research shows that when consumers were asked to rate (on a scale of 1-10) how important it is for their super fund to provide clear information about how much it spends on different items each year:

- Dividends to shareholders is the most likely to be rated 7 or higher out of 10, with 72% of members rating it 7 or more out of 10, ahead of remuneration paid to executives (67%), political donations and gifts (66%) and directors' fees (66%).
- Of the proportion who said that it is extremely important (10 out of 10), dividends to shareholders is second (31%) behind political donations (33%).[41]

Funds must be required by law to disclose payments made to related parties (including dividend or profit payments) to APRA, fund members and the public. Where such payments are material, the trustee must keep records about how those payments are in the best financial interests of members.

Finally, we note that while the changes in Schedule 8 to the *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Act 2019* empower APRA to make reporting standards to collect data on these kinds of transactions on a look-through basis, the standards set by APRA since the amendments were made over three years ago do not appear to require such disclosure. [42]

APRA should update these standards to require disclosure about these kinds of related party transactions and subsequently publish this data. This published data should be complemented by the introduction of a requirement for funds to disclose this expenditure as an aggregate figure in their Annual Members' Meeting notices.

Recommendation 19: Payments to related parties, including dividend or profit payments should be disclosed to APRA, fund members and the public. Where such payments are material, trustees must keep records about how those payments are in the best financial interests of members.

[40] Treasury, *Your Future, Your Super* (October 2020) 17.

[41] UMR Strategic Research, *Tracking public attitudes on superannuation* (October 2022).

[42] We note APRA has collected and published data on some of these transactions in the past – see for example, share of service provider expenses by sector published in the APRA Annual Bulletin up to 2019.

Initial year BFID costings were between $752,000 and $1.3m depending on funds' internal systems and the number of expenditures recorded

Key Takeaways

- BFID cost funds between $752,000 and $1.3m initially, then an estimated on-going figure of $478,000 and $670,000 in costs.[1]
- Over 10 years, BFID will cost all industry funds between $82m and $115m.[2]
- The biggest cost driver was on-going, day-to-day expenses which totalled $504,000 in the first year, accounting for approximately 40% of overall initial costs.
- BFID costing was highly dependent of the number of expenditures recorded as well as the number of requests from APRA, which is a function of fund size, interpretation and fund risk-appetite.
  - Larger funds had more expenditure outflows to cater for their larger membership base, which increased the amount of expenditure recorded,
  - Funds that interpreted reporting at a more granular level also had to prepare, generate and record more expenditure activity, as opposed to aggregating expenditure into higher level categories,
  - More risk-averse funds were highly likely to record more expenditure and do so at a more granular level.
- Funds which implemented near-new systems and processes on assessing business case expenditures also experienced higher initial costs attributed to staff training and process implementation costs. These upfront costs will diminish over time.

Note: 1. based on a fund with approximately 500,000 members and $41bn FUM, the average size of an ISA fund. 2. Based on 31 industry funds with a total of approximately 11,300,000 members and $900Bn FUM

Source: Accenture analysis; Fund consultations

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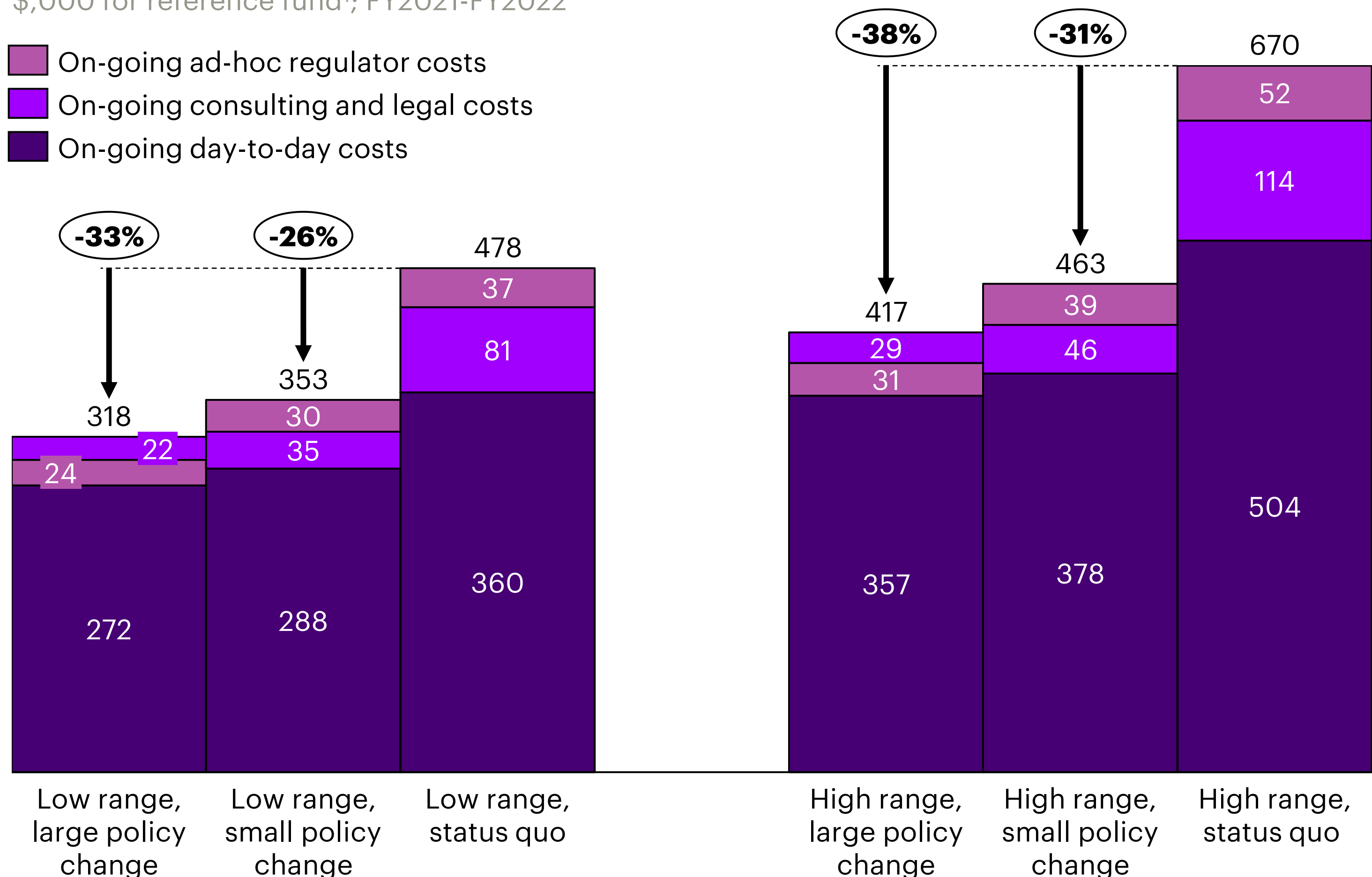
Materiality threshold and regulatory guidance would help lower the amount of analysis and recording of expenditure helping drive down costs



Key Takeaways

- An initial small policy change significantly affects day-to-day costs whilst a larger policy change affects all three on-going cost metrics.

Small Policy Change

- Under a small policy change, funds with higher levels of expenditure recording could save $207,000 while funds with lower expenditure recording could save $125,000. Over 10 years, the policy change could save all industry funds between $21m and $35m.[2]
- Small policy changes assume a materiality threshold and reduces the operational costs with a decrease in the amount of expenditure which needs to be recorded.[3]

Large Policy Change

- Under a large policy change, funds with higher levels of expenditure recording could save $253,000 while funds with lower levels of expenditure recording could save $160,000 while reporting more. Over 10 years, the policy change could save all industry funds between $27m and $43m.[2]
- Large policy changes assume all changes under the small policy change in addition to further reporting guidance, which reduces ad-hoc and on-going legal costs.[3]

Note: 1. based on a fund with approximately 500,000 members and $41bn FUM, the average size of an ISA fund, 2. Based on 31 industry funds with a total of approximately 11,300,000 members and $900Bn FUM; 3. See appendix for detailed modelling assumptions

Source: Accenture analysis; Fund consultations

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Cost framework for quantifying direct costs of relevant regulation

Regulatory Cost = Indirect Costs + Direct Costs

Direct Costs = Fixed Costs + Variable Costs

Fixed Costs

- **Internal** = Snr mgmt. costs of understanding regulation + Staff training costs
  - (Snr mgmt. costs of understanding regulation, Staff training costs) × No. of staff[1] × $/hr × No. of hours worked
- **External** = Legal costs + Other prof. service and capital costs
  - (Legal costs, Other prof. service and capital costs) = Cost per contract × No. of contracts

Variable Costs

- **Internal** = Operational day-to-day costs + Ad-hoc regulator request costs
  - Operational day-to-day costs = No. of staff[1] × $/hr
  - Ad-hoc regulator request costs = No. of hours worked per task × No. of tasks e.g. reported breaches
- **External** = On-going prof. service costs
  - On-going prof. service costs × Cost per contract × No. of contracts × No. of hours worked

Note: 1. Based on a breakdown of the proportion of executive, manager and analyst staff

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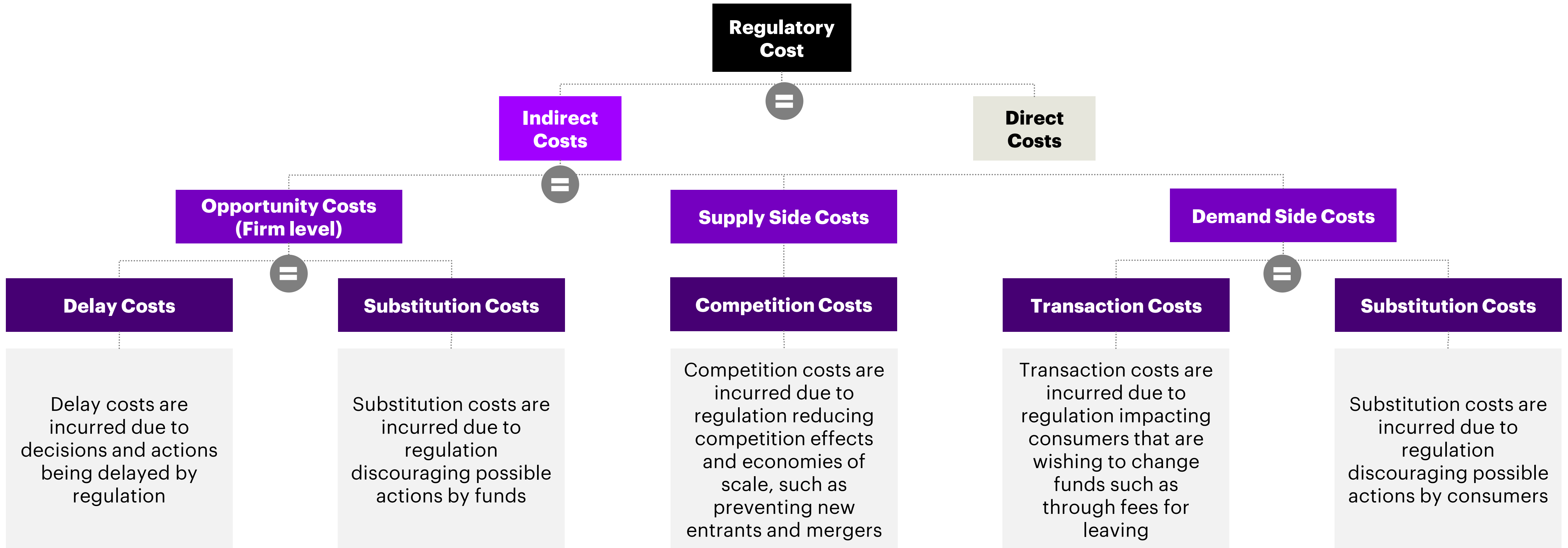
Cost framework for quantifying indirect costs of relevant regulation



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Best Financial Interest Duty Cost Assumptions

		Status Quo (low range/high range)	**Source**	**Small policy change** (low range/high range)	**Large policy change** (low range/high range)	**Reason for policy change**
On-going costs	**Expenditures recorded**	50/70	Fund consultation	40/52.5	40/52.5	Materiality threshold reduced number of expenses which funds need to record
	Hours per expenditure recorded	67.5 hrs	Fund consultation	67.5 hrs	67.5 hrs	
	Ad-hoc requests	Large requests: 5 /7 Small requests: 2.5/ 3.5	Fund consultation	Large requests: 4/ 5.25 Small requests: 2/ 2.625	Large requests: 3.2 /4.2 Small requests: 1.6 /2.1	Materiality threshold and additional clarity means less ambiguity on reporting for funds
	Hours per ad-hoc request	Large requests: 45 hrs Small requests: 37.5 hrs	Fund consultation	Large requests: 45 hrs Small requests: 37.5 hrs	Large requests: 45 hrs Small requests: 37.5 hrs	
	Legal and research hours	162.5/227.5 hrs	Fund consultation	70/91.88 hrs	44/57.75 hrs	Reduction in number of expenses which funds need to record and added clarity means legal and external advice takes less time
Upfront costs	**Understanding regulation and trainings hours**	112.5/225 hrs	Fund consultation	112.5/225 hrs	90/180 hrs	Additional clarity reduces interpretation time
	Initial consulting, IT and legal costs	$180.000/ $430,000		$180.000/ $430,000	$144,000/ $359,000	Additional clarity reduces initial external costs

Note: 1. Distribution of hours worked were done by more junior staff members
Source: Accenture analysis; APRA data; Annual Members' Meeting RIS; Fund consultations

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Industry Super Australia

Your Future, Your Super Review – Performance test methodology supplementary submission

Overview

The introduction of an annual performance assessment has brought important accountability to funds' trustees to ensure minimum performance outcomes are being met in respect to MySuper products.

The performance test regime represents a significant improvement over the self-assessed Member Outcomes regime that preceded it (even though it continues to operate in parallel).

Since its inception the test has identified 14 MySuper products that have failed which collectively managed $60 billion in assets for 1.1 million members.[1] This represents around 7% of total member savings and 8% of member accounts. Without the test these members would be none the wiser.

However, as detailed in ISA's initial submission, it is not obvious whether the outcomes of members in these products have materially improved given only 6% of members in underperforming products have left them and more than half of members remained in a product that failed twice – with the balance either merging into products that passed or trustees made changes to narrowly avoid a second fail.

ISA's initial submission estimated members of underperforming products lost $1.6 billion collectively in the year to June 2022 – even after accounting for fee reductions – relative to members in top performing products. In considering the operation of the performance test and impact on trustee behavior and, ultimately, member outcomes, ISA argues in this submission several shortcomings need to be addressed. These include:

- The transparent publication of data to ensure test outcomes can be properly evaluated and validated;
- The failure of the test to assess the trustee's strategy in addition to implementation;
- The failure of the test to appropriately assess the risk members actually experience in exchange for the net returns achieved over the duration of the test;

[1] APRA MySuper Performance Test 2021, APRA MySuper Performance Test 2022, APRA Quarterly MySuper Statistics (June 2022), APRA Annual MySuper Statistics (June 2021).

- The failure of the test to operate over a sufficiently long duration to properly assess member outcomes over multiple market cycles and not discourage investments in asset classes that have longer investment horizons;
- An inappropriate bias to the calibration of ex-ante administrative fees to avoid technical test failure rather than making trustees accountable for what they have actually delivered to members' accounts in after-fee after-tax net returns;
- A continued lack of neutrality in fee and cost disclosures required under ASIC Regulatory Guide 97 (RG 97), which results in different fee disclosures on similar underlying investments depending on how they are held and offered to members;
- Redesigning the test to eliminate gaming and re-orientating the test towards materially improving member outcomes, and presenting test outcomes in a way that is likely to lead to consumers making better decisions.

ISA makes seven specific recommendations to the performance test methodology to improve the integrity and robustness of the test. While ISA suggests material changes to the performance benchmark methodology are warranted, minor changes could be implemented as an initial step to improve outcomes before effecting more significant changes.

Summary of recommendations

1. APRA should publish product-level SAA domicile and hedging information to enable the performance test to be externally validated as well as publishing the Actual Asset Allocation (AAA) for all products and numerical performance test results.
2. All products should be assessed over at least 10 years or, if the product has operated for less than 10 years, for the life of the product.
3. The basis for RG 97 and related data collections utilised for performance testing should be reviewed to ensure fees and costs borne by members are treated consistently regardless of how products are offered to members (whether directly by a fund or via a platform) and how funds access underlying investments (directly or indirectly).
4. The performance test should be based on the product's RAFE for the duration of the test, and the BRAFE should be member-weighted rather than product-weighted.
5. Consideration should be given to replacing the existing product specific SAA benchmark with a simple naïve benchmark for all MySuper products comprising a simple low-cost diversified portfolio to assess whether trustees are adding value to members savings.
6. Coupled with a simplified transparent test any products that fail be subject to 'a show cause' and more granular assessment of the risk return trade-off for members.
7. APRA should publish dollar value estimates of value add (or loss) to members with a representative balance based on the compounded annual outcome of the performance test.

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Performance test methodology

Key design features of the existing test

Before considering the methodology of the test in detail, it is important to outline its basic structure and operation. The existing test has the following core features:

- Each product is assessed against a benchmark particular to itself with reference to the historical Strategic Asset Allocation (SAA) of the product as determined by the trustee;
- SAA Benchmark portfolio returns for each product are calculated with reference to asset class matched market indices net of tax and efficient investment fees;
- Lifecycle products are assessed at the product level by aggregating the life stages weighted by investments in each life stage;
- Product and benchmark net investment returns are calculated over a duration of eight years and a minimum of five years;
- Reference administrative fees for the product are assessed independently of net returns over the previous 12 months rather than the full duration of the product;
- The benchmark reference administrative fee is the median of all products (not the median paid by members);
- A failure of the test is triggered when the product's 8 year net investment return falls more than 0.5% below the product's benchmark net investment return inclusive of an adjustment reflecting whether the product's most recent 12 months administrative fee is higher or lower than the product median.

Some of the important consequences of these design features are:

- The product tailored benchmarks net out the effect of differences in portfolio construction (portfolio strategy) between products – an important contributor to ultimate returns;
- The trustee sets and can manipulate the construction of the benchmark which their product is assessed against – potentially making the performance hurdle easier to achieve;
- The net returns obtained by members over the duration of the test are not measured or trustees held accountable for;
- The use of a 12 month administrative fee adjustment to net investment returns ascribes a higher weight to admin fee reductions than the rolling average impact of investment fee reductions and the effect of any trustee improvement to investment implementation, let alone strategy (which carries zero weight);
- The use of a median product administrative fee rather than median member fee results in a higher fee assumption for the benchmark than most members pay, resulting in an easier test;
- The duration of the test might be inadequate to assess trustees' actions over the course of more than one market or economic cycle;

- There is no explicit consideration of the *actual* risk taken by members in exchange for the returns they receive.

As we consider the test in detail it is important to understand what factors are captured or not by the test and their relative influence on ultimate member outcomes.

Conceptually this is very important because if the test overlooks important factors that contribute to member outcomes, then it won't discipline or incentivise trustees to address those factors.

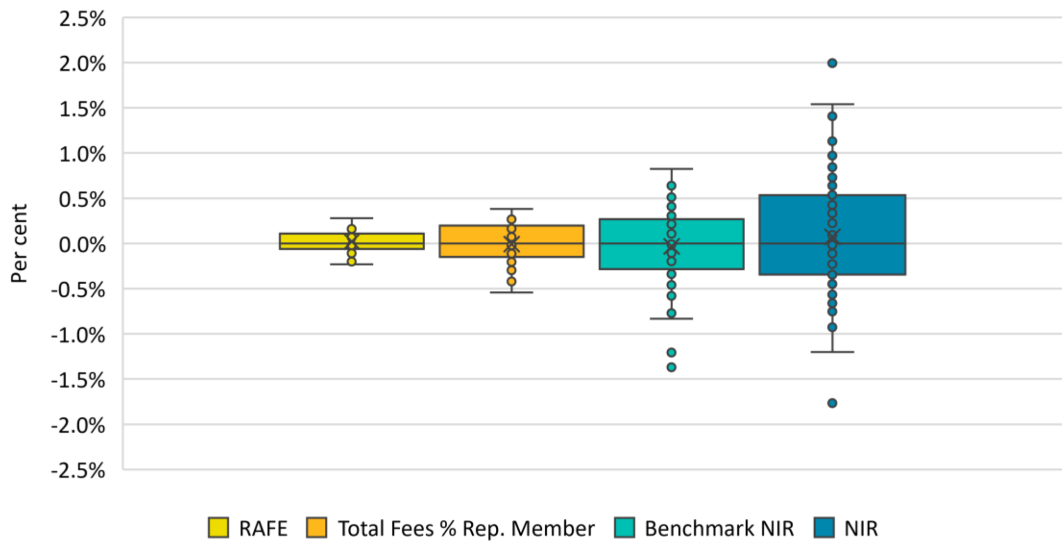
Factors contributing to net return differences

ISA has empirically assessed the potential scale and sources of performance improvement including fees, investment execution, strategy, and how they might contribute to realised net returns. Figure 1 below provides a representation of the relative size of these potential factors to the distribution or spread of net returns experienced by members.

As can be seen moving from left to right in figure 1, differences in administrative fees RAFE vary net returns by less than 0.5%, total fees vary net returns by 1.0%, the actual benchmark investment portfolio by around 2.0%, and observed net investment returns by more than 3.0%.

The spread between the best and worst observed net 8 year returns is almost 4.0% and the spread between the median net return is around 2.0% to the best and almost 2.0% to the worst net return.

Figure 1: Spread of factors affecting net return
Year to June 2022



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual Superannuation Performance Test - 2022, APRA Quarterly Superannuation Performance Statistics (June 2022).

Given admin fee differences alone have only a modest bearing on net returns of MySuper products, the relative importance the test ascribes to the reference admin fee is curious. Moving a product from the highest to lowest fee could theoretically improve their test outcome by 0.5%, which is just a fraction of the 3.0% difference in the observed net investment returns.

A change in total fees could be more meaningful but at most could improve the test outcome by one third if sustained. Evidently more than two thirds of observed performance differences are due to factors other than fees, including the strategy (underlying asset allocation) and its execution – yet the existing performance test doesn't reward trustees for the portfolio asset allocation – which has the potential to have more than twice the impact of fee reductions.

Is the test improving member outcomes?

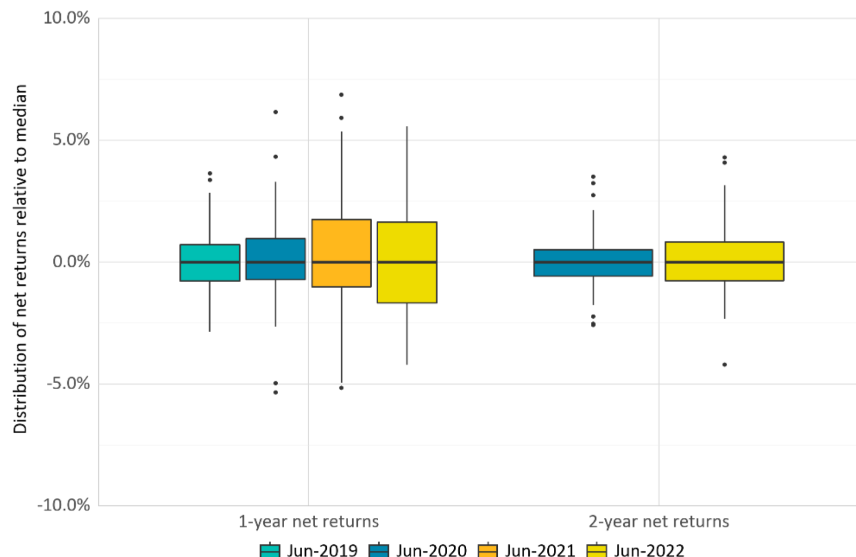
Before considering in detail the test methodology it is useful to assess after two rounds of the test whether the objective of the test is being achieved empirically.

Decomposing improved outcomes and attributing the drivers is a difficult task. However, the starting point is whether the operation of the test has caused poor performing products to 'lift their game'.

If this were the case, we would expect to see fee reductions and a greater focus on investment strategy and implementation result in a narrowing in the distribution or spread of net returns among products. Specifically, we might expect to see products in the bottom two quartiles begin to close the gap to median returns and observe a tighter distribution of below median returns. Figure 2 below shows the distribution of returns for the last four years – two years immediately preceding the inaugural Your Future Your Super (YFYS) performance test, and two years after.

Remarkably we see the return spread increase after the commencement of the test in each of the two years after the test compared to the two years before. This is the case for both below and above median returns. So rather than closing the gap in return outcomes we have at this early stage seen a widening in the performance gap between the poorest products, median products and top performing products.

Figure 2: ***Distribution of product level net returns, 2019-2022***

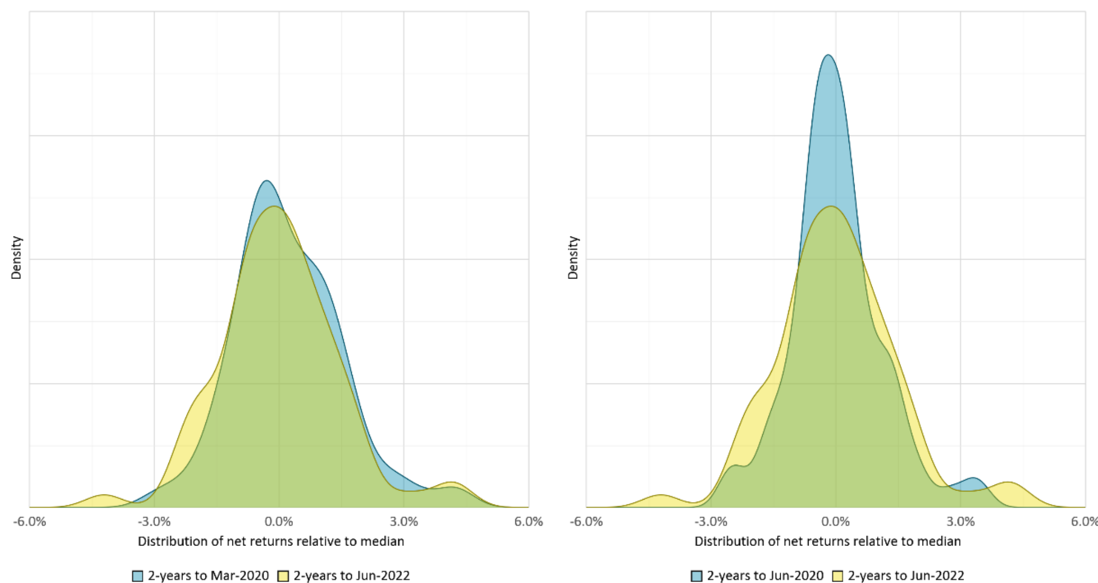


Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).

It is possible this outcome is unrelated to the commencement of the performance test. For example, we might expect during abnormally good or poor investment return periods magnification of portfolio

return differences. To assess this possibility, we examined rolling two-year returns at quarterly intervals and calculated average returns and product volatility. We then matched two periods before and after the test with similar average return outcomes and volatility. A density plot of similar periods before and after the test relative to the median is shown below (figure 3). As can be seen, the distribution and range of product returns has not narrowed since the introduction of the tests,[2] with a number of poor performing products achieving significantly lower returns relative to top performing products.

Figure 3: ***Density plot (distribution) of MySuper product two-year net returns***
Before and after the introduction of the YFYS performance test



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).

Importantly these outcomes incorporate trustee responses to the performance test including fee reductions among products failing or close to failing the test. The nature of these fee reductions is discussed further later in this submission however it would appear they didn't materially close the net return gap.

The relationship between performance test outcomes and net returns

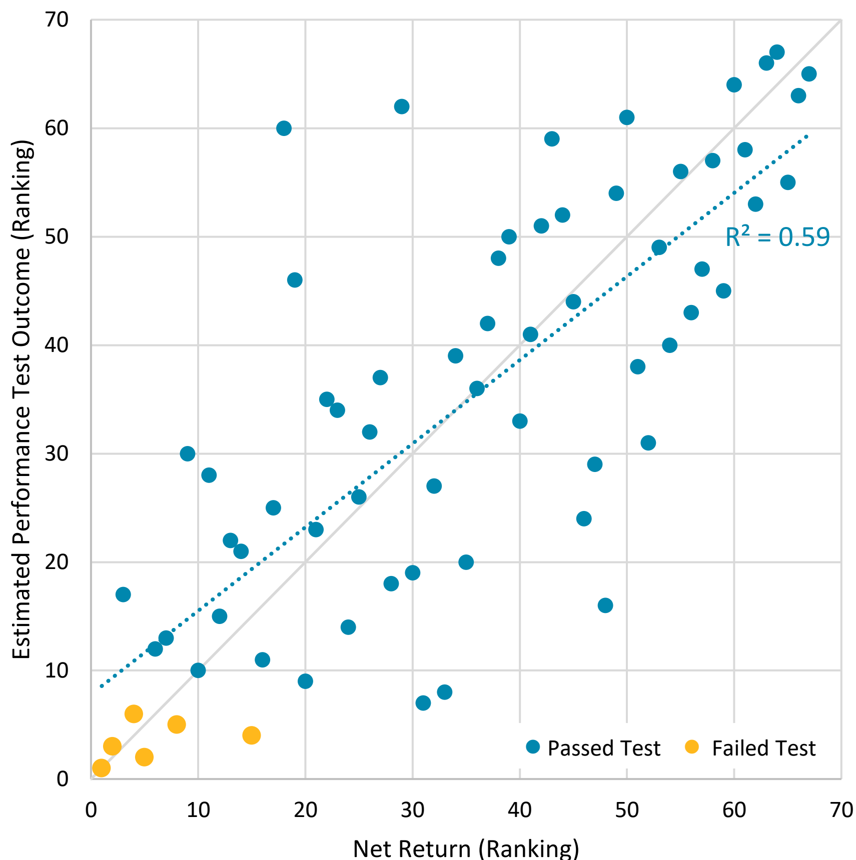
In considering whether the test is leading to an improvement in member outcomes (measured by net returns) it is worthwhile examining the strength of the relationship that exists between the performance test and net returns.

It is evident the test is identifying underperforming products. Figure 4 below shows the relationship between the test ranking and net returns. The products which failed the test (identified by red dots) also had poor net return rankings and so are clustered in the bottom left corner.

[2] In fact, we find evidence at the 5 per cent level of significance that variation in MySuper product net returns in the 2 years to June 2020 is lower than in the 2-year to June 2022.

However, the relationship between performance test outcomes and net returns is not directly linear. There are many outliers where either the product's performance test ranking is apparently adequate (despite the product ranking as poor or failing on a net return ranking), or the product has a relatively solid net return but poor performance test results.

Figure 4: ***Relationship between performance test rank and net return rank***



*Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual Superannuation Performance Test – 2022, APRA Quarterly Superann*uation Performance Statistics (June 2022).

While on face value there appears to be a relationship between net returns delivered to members and performance test outcomes, it is much weaker than might be expected. A regression between the net return ranking and the performance test rank suggests only 59% of the performance test outcome can be explained by the actual returns delivered to members ($R^2 = 0.59$).

While the role of risk is discussed below, it is likely this relationship is not a causal one. Recalling that the performance test assesses the trustee's implementation of their strategy, it is plausible that trustees capable of implementing a strategy well are also likely to devise a quality strategy in the first place.

However, the absence of a more robust statistical relationship does raise issues around the design of the performance test and its potential failure to predict net return performance delivered to members, which is the key metric that will determine their final retirement savings.

Transparency and integrity

Empirical evaluation of the performance test to contribute constructively to this review was not a simple task due to a lack of transparency around performance test inputs and outcomes.

Since the inaugural test, APRA, has undertaken the performance assessments using product level data that is not contained in its statistical publications or otherwise publicly available.

Information on selected product-level strategic asset allocation domicile and hedging, while reported by funds to APRA, is not published, making it very difficult to validate the test results and assess its sensitivity to changes.

For ISA to evaluate the second round of the performance assessment we have sought this data directly from ISA member funds or have otherwise used sector level domicile and hedging information with a correction factor based on last year's performance test outcomes.

Seeking to replicate the latest test has been necessary as the regulator won't publish the 2022 numerical performance test outcomes other than a pass or fail until it releases its heatmaps later this year. As a consequence, this review is being conducted with only one out of two years performance test results in the public domain – which by any measure is unsatisfactory.

Other important data that would be useful for evaluating the integrity of the test is also not published, such as product-level actual asset allocations (AAA). The basis for doing so is discussed in the next section.

Until this information is transparently reported, ISA has concerns about the integrity of the performance test including the ways in which Strategic Asset Allocations (SAAs) might be manipulated by funds to pass the test.

Recommendation: APRA should publish product-level SAA domicile and hedging information to enable the performance test to be externally validated as well as publishing the Actual Asset Allocation (AAA) for all products and numerical performance test results.

Gaming of the SAA benchmark

As noted above, products are assessed against a product-tailored benchmark which references the SAA of the product and not the actual asset allocation of the product. Because the SAA is determined by the trustee and there is no specific obligation for it to reflect the actual asset allocation, there is the opportunity for the benchmark to be gamed.

In effect trustees can manipulate the SAA such that it could be reasonably expected to deliver a lower portfolio return than the AAA – in other words, the trustee can lower the hurdle return which they must clear.

It is not possible to independently determine the extent of such manipulation since APRA does not publish the AAA of products to assess how they might deviate from the SAA.

Nevertheless, there was a potential insight into such activity at the commencement of the performance test where a subset of MySuper products significantly revised their historical SAA (thus changing the benchmark portfolio they were assessed against).

Evidence of gaming

In the lead up to the first round of performance tests, 35 MySuper products revised their historical SAA benchmarks with most reducing exposure to 'Other' investments and increasing exposure to Cash and Fixed income (see figure 5).

The Other investments benchmark index has averaged 5.1% per annum over the 8 years to June 2022, compared to 1.8% per annum for Fixed income and 1.2% per annum for Cash, so this behaviour increased performance test outcomes by shifting the SAA to categories with lower returning benchmark indices.

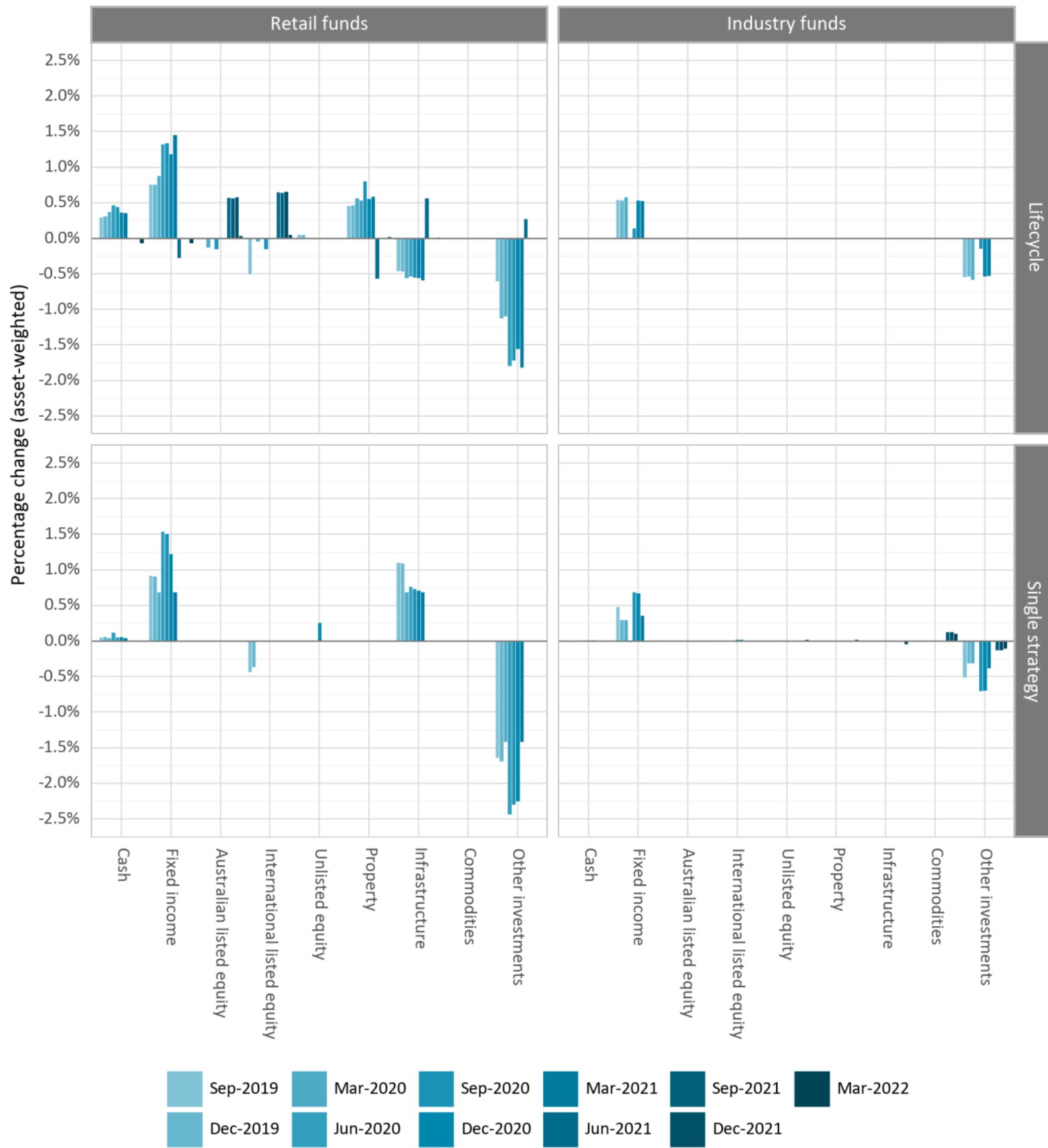
While there was in some instances a legitimate case for trustees to reallocate assets in the 'other' category to better reflect the underlying assets, there were surprising differences in the extent of this re-allocation across sectors.

The behaviour was particularly prevalent in the retail sector which accounted for 20 of the 35 product revisions. Revisions were more likely among lifecycle products and among these 84% of SAA revisions were from retail MySuper products. Furthermore, across both lifecycle and single strategy products the extent of reallocation (as a share of assets) was around three times greater magnitude among retail MySuper products than industry MySuper products.

The ability of funds to influence their product's benchmark returns via changes to their SAA opens the prospect of gaming within the system. In effect trustees can improve their performance test outcome not by increasing the performance of the product, but by lowering the bar to which the product is assessed against.

This reduces the efficacy of the performance tests and weakens their ability to improve member outcomes.

Figure 5: ***Revisions to SAA in the lead-up to performance tests***
Weighted average assets of all funds by sector



Source: ISA Analysis, APRA Quarterly MySuper Statistics (March 2021, June 2021, March 2022 & June 2022).

The duration of the test is too short

In general, products should be assessed over the longest time period possible to account for risk and market cycles, and to reflect that superannuation is a long-term investment.

Market and economic cycles and other regulatory guidance

ISA's analysis of the economic and financial market cycles in Australia shows that over the last few decades, financial market cycles have slightly shortened (to a median of 2.9 years over the period from 1984 and 2020) while economic cycles have substantially lengthened (to a median of 18.6 years from 1984 to 2020). Assessing performance over multiple market and ideally economic cycles allows for a better assessment of the resilience of investment portfolios, along with trustees' responses.

Additionally, the Conexus Institute found that using an 8-year period to assess returns will mean that for every six poor funds, the test will likely misidentify one as a good performer.[3] This reflects that over 8-year intervals, a poor fund may experience annualised performance above the threshold level. This is an unacceptably high risk of false positives.

Support for 10-year timeframe for assessing returns is also found on the Government's own Moneysmart website. The explanation given about how to choose investments uses a 10-year timeframe to show average returns.[4] Similarly, under the MySuper product dashboards legislation, funds are required to work out a return target for a period of ten years and the return for the previous ten financial years, or the period the product was offered.[5]

Discouraging investment in Venture Capital and early-stage Private Equity

The look-back period has important implications for portfolio construction and the inclusion of asset classes that are illiquid and have inherently long investment horizons. This is especially the case for Venture Capital (VC) and early-stage Private Equity investments. They commit capital in the very early stages of an enterprise many years before relevant products or services are ready for market with the expectation of valuations surging once positive cashflows and profits are attained. This lag (known as the 'j-curve') means the commitment period can be as long as 8-10 years for the specialist funds established for such investments. As a consequence, the existing lookback period may deter new allocations to VC thus distorting investment decisions and reducing the universe of assets that members are exposed to, reducing diversification and risk-adjusted returns.

Recommendation: All products should be assessed over at least 10 years or, if the product has operated for less than 10 years, for the life of the product.

Test fails to capture poor risk-return outcomes for members

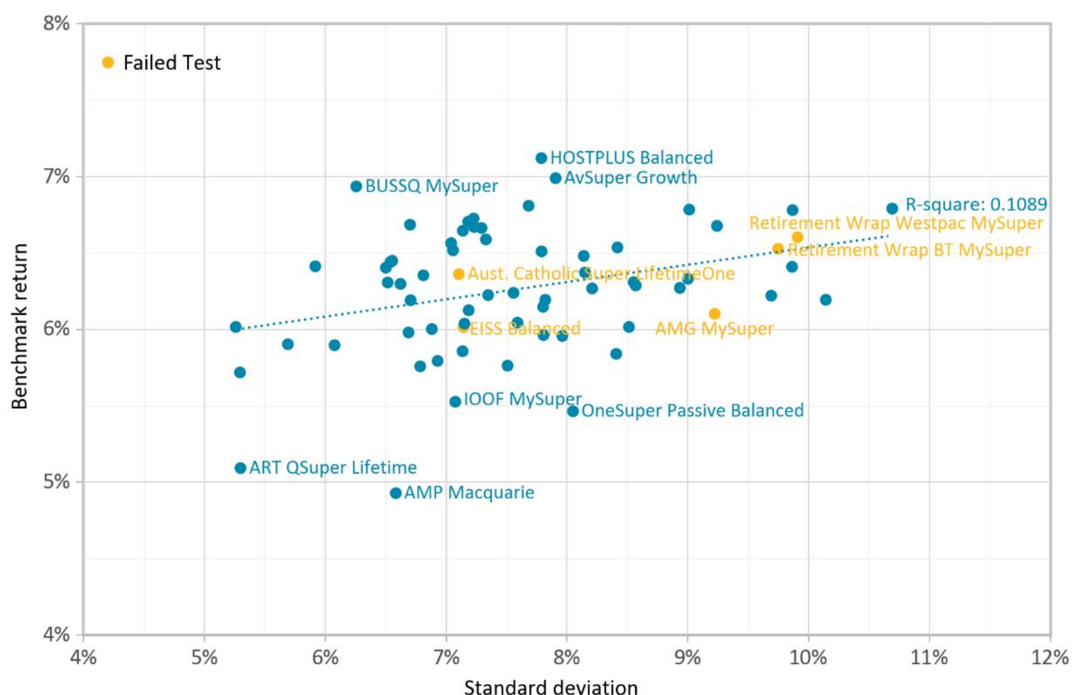
A common criticism of the YFYS performance test is that it doesn't explicitly assess the risk members are exposed to in exchange for the returns they receive. Whether this is relevant for a relatively

[3] The Conexus Institute, *Working Version: Review of the Your Future Your Super Performance Test* (20 November 2020).
[4] Moneysmart, *Choose your investments* (accessed 14 October 2022).
[5] Division 2E of Part 7.9 of the *Corporations Regulations 2001*.

standardised product like MySuper is open to debate, but it is useful to examine in the context of the review and the efficacy of the test.

To some degree the performance test does attempt to take risk into account by constructing product-specific benchmarks that are matched to the supposed asset allocation of products. In theory, a product with a riskier asset allocation will have this reflected in the benchmark, thus attempting to control for risk in the performance assessment. In theory this makes some sense as figure 6 below shows. It reveals an expected (but not directly linear) relationship between the MySuper products benchmark returns and risk (measured by the volatility or standard deviation of returns).

Figure 6: ***Risk return of MySuper product benchmarks***
Eight years to June 2022



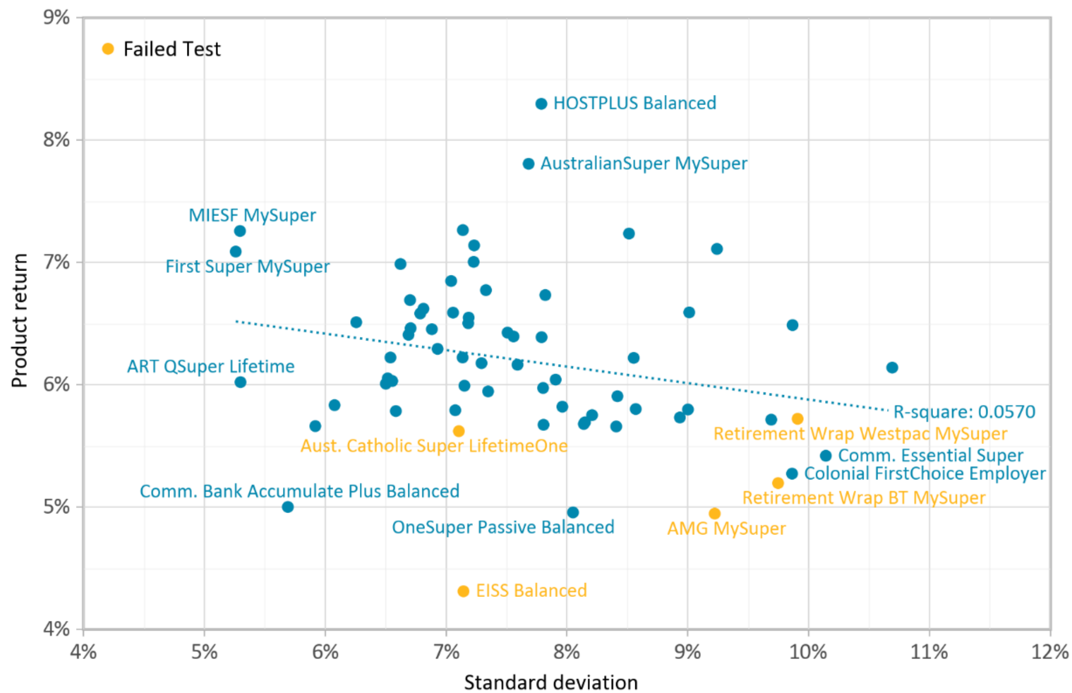
Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual Superannuation Performance Test – 2022, APRA Quarterly Superannuation Performance Statistics (June 2022).

There are two possible ways to interpret such results when comparing two products:

- Firstly, you can identify products with a similar return (y axis) and then assess which has delivered that return with the lowest risk horizontally (x-axis);
- Alternatively, you can identify products with similar risk (x-axis) and then assess which has delivered better returns in exchange for that risk vertically (y-axis).

However, what is more revealing is examining the actual (or realised) risk return of MySuper products, which is shown in figure 7 below.

Figure 7 – Observed risk return of MySuper Products 8 years to June 2022



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).

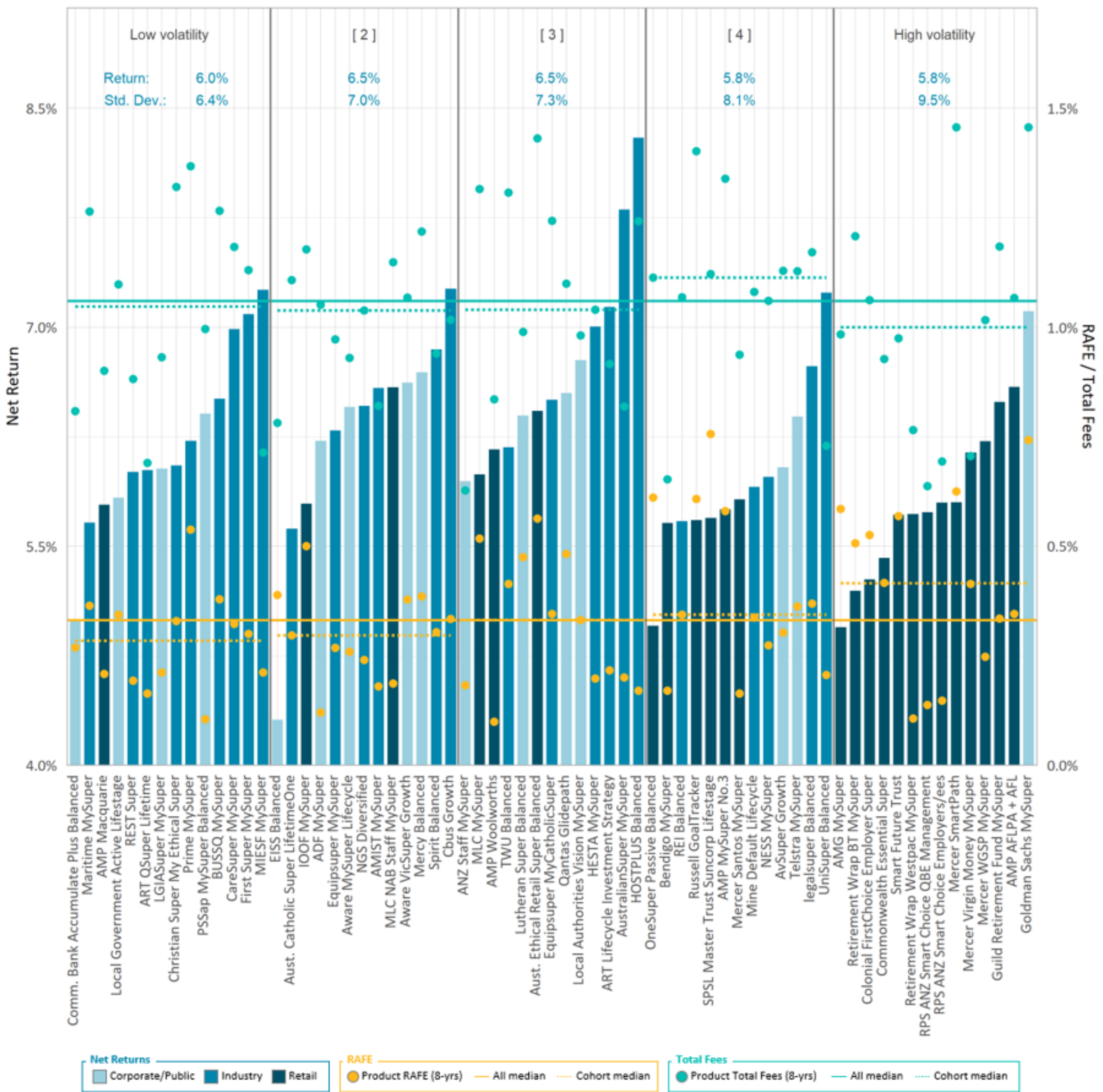
Evidently there are significant differences between the benchmark risk return outcome and the observed risk return outcome.

Specifically, the relationship for observed risk return outcomes is slightly negative because some of the poorest performing products are also the most volatile. This is very unusual and could be explained by three things.

- Firstly, the benchmark SAA for some of the products might not reflect riskiness of the investment portfolios employed.
- Secondly, it is possible asset selection decisions within the asset allocations are riskier and lower returning than the benchmarks.
- Thirdly, is that the fees for the products are significantly higher than the benchmarks resulting in returns being substantially lower despite exhibiting similar volatility to the benchmark.

To shed further light on the issue, figure 8 below quantiles the MySuper products by their observed volatility (least volatile to most volatile) whilst comparing their returns and fee levels.

Figure 8: MySuper product net returns and fees, ranked by volatility



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).

There are a number of observations that can be made from this analysis:

- The highest average net returns (and best risk return trade-off) can be found among mid volatility MySuper products;
- There are not marked differences between either administrative or total fees across the cohorts;
- Although the highest volatility / lowest return cohort have higher than average administrative fees, the median total fee of the cohort is lower than average;

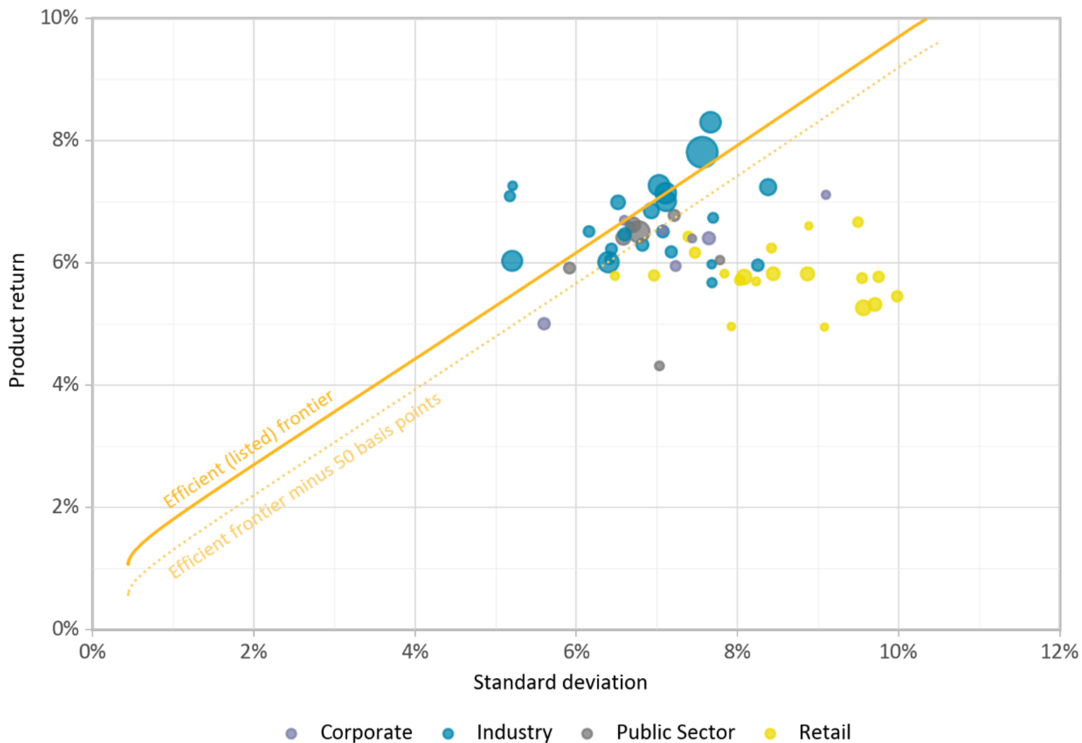
- For this cohort it is possible the current year RAFE and total fees don't accord with long term fees of the products or the RAFE and total fees are an underestimate;
- Almost all (13 of 14) products among the high volatility low return cohort are retail MySuper products.

This analysis suggests further examination of the way fees are measured in the performance test is needed as well as a more detailed consideration of risk return efficiency, particularly if a simplified benchmark is pursued.

Measuring risk return efficiency

An alternative way of assessing the risk return efficacy of MySuper products is to benchmark them on their returns and observed volatility compared to an efficient investment frontier – see figure 9 below. This type of analysis effectively standardises returns based on risk quotas, and based on thousands of portfolio simulations constructed from low risk to high risk.

Figure 9: ***MySuper product returns and volatility vs efficient frontier***
Eight years to June 2022



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA performance test benchmark indices (see page 22 of Treasury Laws Amendment (Your Future, Your Super—Addressing Underperformance in Superannuation) Regulations 2021 for details).

While the volatility (standard deviation) of returns is only one measure of risk, it is one which members are most likely to notice. A key finding of this analysis is that most retail MySuper products are risk return inefficient – exposing members to up to twice the risk than their returns justify or around 2% per annum lower returns than other MySuper products with similar or lower risk.

These systemic differences in the observed risk return efficiency of MySuper products warrants closer examination by the review.

Performance test treatment of fees

In its 2018 report into superannuation efficiency and competitiveness, the Productivity Commission found a relatively clear relationship between observed fees and net return outcomes consistent with published academic literature. Using option level data, the Commission found a strong negative relationship between net returns and total fees.[6] In its cameo analysis, the Commission found that a 0.5% difference in fees can cost a full-time worker about 12% of their balance (or $100,000) by the time they reach retirement.[7]

It is therefore appropriate that the performance test seeks to capture fees, although it does so in a most unconventional way. As noted, the performance test backs out the effect of administrative fees from historical net returns by using a net investment return metric for the benchmark with an ex-ante administrative fee adjustment reflecting the fee a trustee sets in the year a performance test is conducted.

This approach was not consulted on when the exposure draft regulations were originally released[8] – on the contrary, the draft regulations envisaged the use of the full lookback period for administrative fees – in effect treating them in the same way as investment fees and costs.

The changes which were made public only when the final regulations were made were largely the result of lobbying by the retail sector which has historically attempted to obscure or remove entirely the effect of administrative fees and commissions on net returns.[9]

The consistent attempts to obscure the effect of such fees on net returns had previously led the Cooper Review to conclude:

> It is illogical and misleading for investment returns to be reported to members on anything other than an after tax-basis and after all costs have been deducted.[10]

As it stands the treatment of fees and how they are measured in the test results in an unexpected relationship between net returns and total fees, and a seemingly incomprehensible relationship

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[6] Productivity Commission, Superannuation: Assessing Efficiency and Competitiveness, Report 91, December 2018, box 3.4 p. 186 and figure 3.2 p. 187.
[7] Ibid – Cameo 3, p. 14.
[8] Treasury consultation – Your Future Your Super Regulations and Associated measures, 28 April 2021-25 May 2021, https://treasury.gov.au/consultation/c2021-162375.
[9] For example, the Financial Service Council in 2010 proposed to make a new reporting standard for its members (Standard 6B) which would have required its super fund members to report returns net of tax and investment costs but gross of administrative and adviser fees paid by members.
[10] Super System Review Final Report – Part 2 page 111

between net returns and the default ranking in the ATO performance tool (using fees) – see figure 10 below.

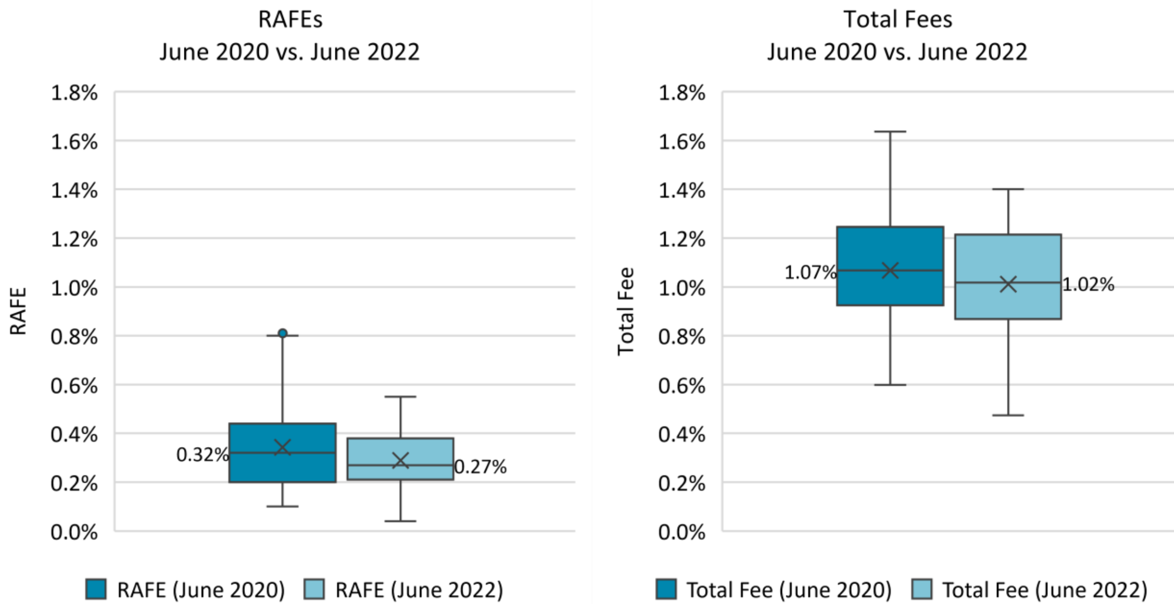
Figure 10: Net returns and total fees 8 years to June 2022; Net return and ATO YourSuper tool rank

Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), ATO YourSuper Comparison Tool (June 2022).

Fee changes since the inception of the test

Since the inception of the test there is no doubt RAFEs have declined with a diminished spread between the lowest and highest RAFEs. Median RAFEs for a representative member have declined by a modest 0.05%. Total fees have reduced by a similar quantum – see figure 11 below:

Figure 11: Change in the distribution of product RAFE's and total fees, 2020-2022



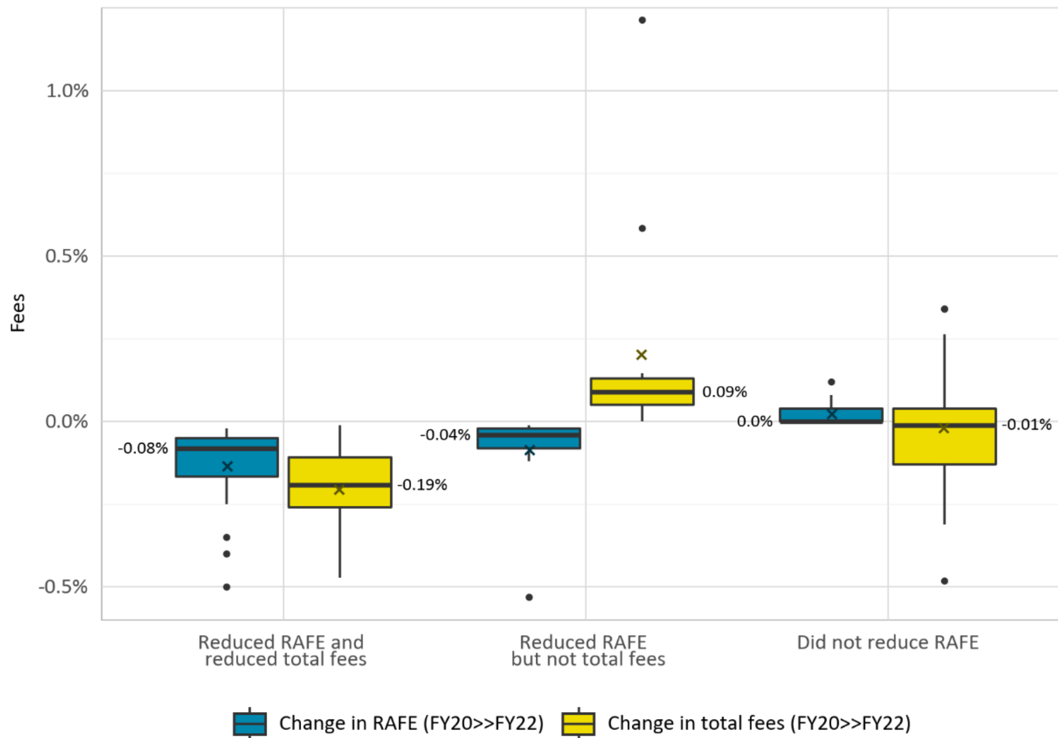
Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).
Note: Analysis for total fees exclude products with no Total fee data for June 2020.

On face value this is positive but further examination is warranted particularly since administrative fees and investment fees can move independently of one another. In terms of fee adjustments for the 67 products subject to the 2022 performance assessment:

- 36 reduced RAFE (around half of total products) and 31 did not reduce RAFE;
- But of the 36 that reduced RAFE, 23 had a reduction in total fees and 13 did not – either no change or increase;
- 40 products had a reduction in total fees (the median reduction was 0.15%).

The administrative and total fee changes for these three cohorts is shown below in Figure 12.

Figure 12: Change in fees 2020-2022, by fee change cohort



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).

When these representative member fee changes are applied to each product's funds under management, there was a total of $410 million in fee savings for products that reduced their fees but after accounting for products that reported increases in fees the net change was an increase of $558 million.

How fees are measured – the effect of RG 97

This does not seem like an intuitive or expected outcome from the performance test, but it likely reflects ongoing issues with fee disclosure under RG 97 which has seen some notional fee increases of many high performing products (including for instance defining taxes such as stamp duty which are levied on the acquisition of real assets purchased directly by funds as fees). As figures 2 and 3 above show, it is not apparent that the way fees have been redefined by RG 97 is having any impact on net return outcomes for members.

Changes in product level fee disclosures that bear little relationship to after-fee and after-tax return outcomes experienced by members suggest ongoing problems with fee disclosures related to RG 97. In many instances trustees have been required to disclose arbitrary changes associated with how fees and costs have been defined by RG 97 rather than any change in underlying fees or costs borne by members.

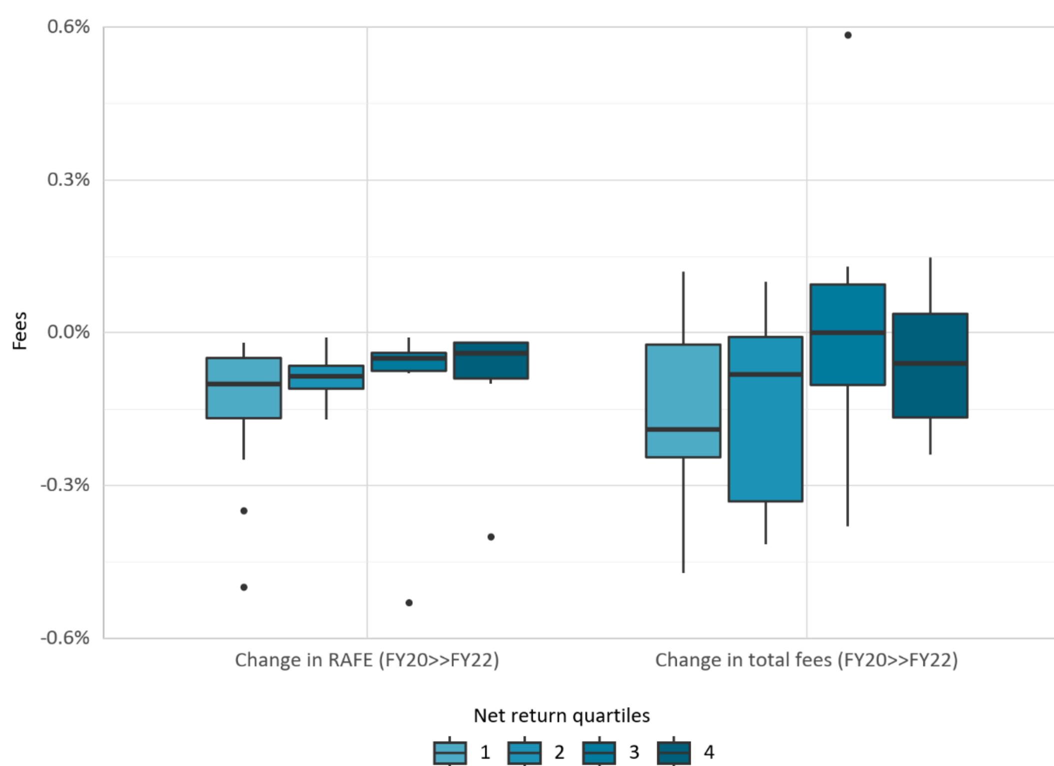
Additionally, concerns remain about the neutrality of the disclosures linked to the way in which funds offer investment options to members (whether directly by the trustee or via platforms) and the way in which funds acquire and hold assets.

Recommendation: The basis for RG 97 and related data collections utilised for performance testing should be reviewed to ensure fees and costs borne by members are treated consistently regardless of how products are offered to members (whether directly by a fund or via a platform) and how funds access underlying investments (directly or indirectly).

Fee changes by performance rank

It's useful to consider the distribution of fee changes by net return cohort to assess where fee changes are occurring. Figure 13 below shows the distribution of fee changes from 2020-2022 by 8-year net return quartile.

Figure 13: Fee change distribution by net return quartile



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022).

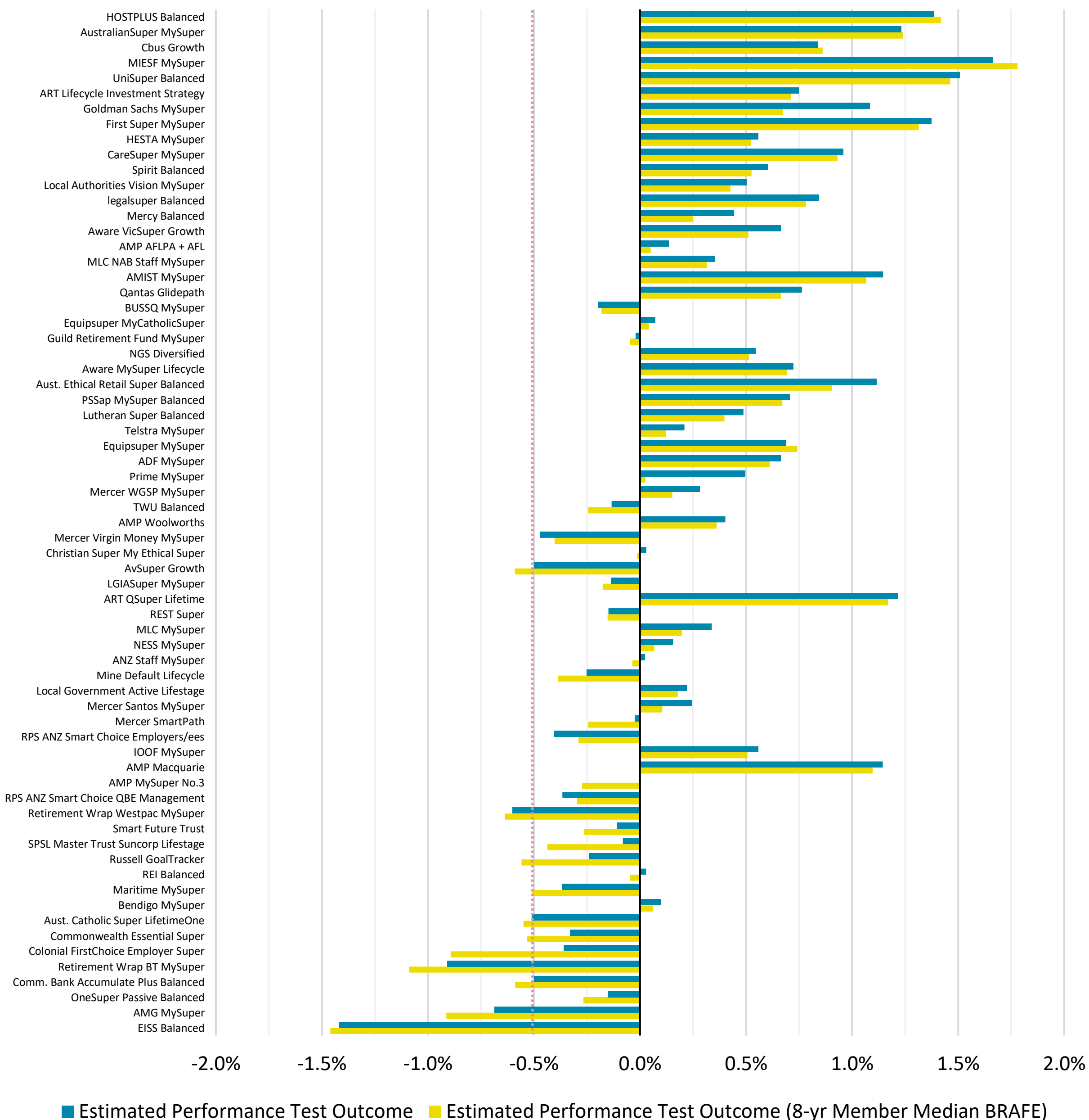
At the median level, fee reductions are evident among funds in the bottom two quartiles by performance rank although the median change in total fees is between 0.1% to 0.2%. While this is clearly welcome it is not sufficient to materially improve member outcomes for members in these poorer performing products and as previously shown it is not apparent it is helping to close the net return gap to better performing products.

Overall impact of the 12-month RAFE on performance test outcomes.

The use of a 12 month RAFE in the performance assessment has had a significant impact on the performance test results.

Figure 14 below shows estimated performance test outcomes had the final regulations reflected those originally consulted on in May last year, with the exception of using a median member rather than median product fee.

Figure 14: Estimated performance test outcome vs 8 year BRAFE/ RAFE, June 2022



Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual Superannuation Performance Test - 2022, APRA Quarterly Superannuation Performance Statistics (June 2022), APRA Annual MySuper Statistics (June 2021).

Overall, the decision to use a 12-month administrative fee rather than an 8-year administrative fee fully reflected in the net returns of each product coupled with the use of an 8-year member median

benchmark administrative fee has a significant impact on the overall outcomes. Specifically, the final regulations reflected in the current test:

- More than halved the number of products failing from 11 to 5 in the 2022 test.
- Improved the test outcomes by an average of 0.06% overall but 0.10% for corporate MySuper products and 0.20% for retail MySuper products.

An important outcome from the emphasis placed on the 12-month administrative fee is that it has permitted trustees who have been running otherwise failing or near failing products to reduce administrative fees modestly to pass the test but have only marginal overall improvement to net return outcomes to members relative to superior products.

Objectively assessed, rather than improve member outcomes it has, in all likelihood, had the opposite effect – it has allowed poor performers to evade the consequences of test failure including informing their members they are in a poor performing product and to find better alternatives.

Impact of using a median product RAFE rather than member account RAFE

The more appropriate benchmark is the median member *account* RAFE across all APRA super regulated MySuper products, 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. The number of products is also unstable and subject to change.

Using the median member fee would better reflect the representative typical fees paid by members reflecting the benefits of scale achieved by funds which have higher membership bases.

ISA analysis of the median product fee in 2021-22 reveals it is set at a level that is higher than what two-thirds of MySuper members pay, equal for 8 percent of members, and is lower for just 27 percent of members.[11]

The selection of the median product fee is not representative of what members pay and makes it easier for high admin fee products to meet the performance test.

Additionally, there is no basis for a separate administrative fee benchmark for different product types.

Using a separate administrative fee benchmark for trustee-directed and other choice products may inappropriately entrench high fees with significant profit margins.

The performance tests should be based on administration fees for the full duration of the test so that they both: accurately reflect the outcomes received by members; and incentivise funds to not only reduce administration fees but to keep them low. Further, the benchmark administration fees (BRAFE) should be based on a member-weighted administration fee rather than a product-weighted fee.

[11] Source: ISA Analysis, APRA Quarterly MySuper Statistics (June 2022), APRA Annual MySuper Statistics (June 2021).

Recommendation: The performance test should be based on the product's RAFE for the duration of the test, and the BRAFE should be member-weighted rather than product-weighted.

Alternative benchmarking approaches – a Simple Reference Portfolio

Allowing funds discretion to select their own benchmarks and account for fees from the previous year only has created a gulf between passing the performance test and achieving better member outcomes.

Evidence showing funds have gamed the test by selecting easier benchmarks and selectively reducing fees supports the need for a different approach.

A better approach is likely to be found in using a simple reference portfolio, or naïve benchmark, to assess the performance of products and answer the question – is value being created for members?

That is – are sophisticated investment managers adding value for members, over and above what members could achieve if they invested in a 'simple', low-cost portfolio of potential investments?

New Zealand's Sovereign Wealth Fund uses a Simple Reference Portfolio

New Zealand's Sovereign Wealth Fund, the New Zealand Super Fund, has used a Reference Portfolio as its benchmark since 2010.

The Reference Portfolio serves as a representative alternative portfolio to the actual portfolio that the Fund invests in. It is a notional low-cost, passively managed, and well-diversified portfolio of listed asset classes that are consistent with the Fund achieving its return objectives without undue risk.

The Fund exercises judgement in constructing its actual portfolio, based on its assessment of current asset pricing from long-term fair value. These decisions can then be compared with the alternative of simply holding the Reference Portfolio. In this way, the Reference Portfolio is a device used to hold management to account for its actual portfolio decisions.

The Reference Portfolio differs from the SAA approach in that:

- It is a benchmark, not a guideline for the actual portfolio's composition,
- It contains traditional asset classes only, and
- It is not affected by short-term market conditions.

Compared to the use of an SAA, it encourages a greater separation between governance and management. It allows the Fund to focus on long-term strategic decisions and how they can add value over and above what can be achieved by simply implementing the Reference Portfolio.

The Reference Portfolio is subject to five-yearly reviews to ensure it remains appropriate, with the last occurring in 2020.[12] Key considerations for the review included composition of the portfolio, expected return and risk, interest rate and inflation risk hedging, currency hedge ratios and benchmark indices. It

[12] Hyde, Carly Falconer, Christopher Worthington and Matthieu Raoux, "How We Invest" White Paper, The 2020 Reference Portfolio Review, January 2021, at https://www.nzsuperfund.nz/publications/papers-reports-reviews/how-we-invest-white-paper/.

was decided to retain the asset allocation of 80 per cent to growth assets and 20 per cent to income assets. The main change from the 2015 review was the decision to combine developed and emerging market equities into a single building block, global equities.

A naïve reference portfolio, or variations on it could be readily implemented to assess MySuper products which are designed for relatively disengaged members. The use of a simplified test should be complemented by a follow up assessment of products which fail, allowing any claims related to the underlying risk of the products to be considered carefully.

Recommendation: Consideration should be given to replacing the existing product specific SAA benchmark with a simple naïve benchmark for all MySuper products comprising a simple low-cost diversified portfolio to assess whether trustees are adding value to members savings.

Recommendation: Coupled with a simplified transparent test any products that fail be subject to 'a show cause' and more granular assessment of the risk return trade-off for members.

Measuring value added

Using the Reference Portfolio as a benchmark means the Fund can quantify the value it creates over and above what the Reference Portfolio would achieve (table 1).

For example, over the past 10 years, the New Zealand Super Fund has exceeded the Reference Portfolio return by 1.93% per annum, or NZ$9.26 billion (after costs, before tax).[13] In recent years, the composition of the Fund has become increasingly different to the Reference Portfolio, and the Fund has moved visibly ahead of the Reference Portfolio's returns.

Table 1: Measuring value added by the New Zealand Super Fund
Fund performance (after costs, before tax), 30 June 2021

	Ten years *per cent pa*	Five years *per cent pa*	One year *per cent*
Actual fund returns	13.01	13.87	29.63
Reference portfolio return	11.08	12.64	27.90
Value added (actual return *less* reference portfolio return)	1.93	1.23	1.73
Estimated $ earned relative to reference portfolio	***$9.26 b***	***$2.92 b***	***$0.76 b***

Source: New Zealand Super Fund, Returns compared with the reference portfolio: https://www.nzsuperfund.nz/performance/investment/returns-compared-to-the-reference-portfolio/

[13] See https://www.nzsuperfund.nz/performance/investment/returns-compared-to-the-reference-portfolio/.

The ability to measure the value added by adopting a particular strategy, not just implementing a given strategy, is a critical feature that should be measured by a performance test. Yet it is a key feature missing from the current YFYS test.

Such value-add calculations can be made at the fund level but also at the representative member level, showing a member how much they have gained (or lost) relative to the benchmark, as well as to better assess the differences across products.

To illustrate a member-focused presentation, ISA has constructed a naïve 70/30 reference portfolio to assess MySuper products against. Using similar fee assumptions to the APRA performance test, seven products underperformed the 70/30 portfolio. Figure 15 below shows the outcomes of an 8-year net return comparison to a naïve portfolio consisting of 70 percent listed equities (equally split between domestic and international) and 30 percent fixed interest (domestic and international) and cash.

As figure 15 below demonstrates, outcomes at a member-level vary significantly from a loss of almost $7,000 over 8 years from the worst product to a gain of $17,600 for the top performing product – a difference of almost $25,000. The publication of member-level value-add could significantly improve member engagement around performance and lead to the selection of better products and enhanced member outcomes.

Recommendation: APRA should publish dollar value estimates of value add (or loss) to members with a representative balance based on the compounded annual outcome of the performance test.

Figure 15: MySuper member value-add compared to 70/30 naïve portfolio

Eight years to June 2022