Mercer

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Dear Shibani

Mercer welcomes the opportunity to provide feedback to the Your Future, Your Super Review and, in particular, to the questions outlined in the Consultation Paper.

Australia's superannuation system is critically important to millions of Australians to enable them to have a dignified retirement with confidence about their financial future. Our retirement income system is well-respected overseas and ranked sixth out of 44 systems in the recently released Mercer CFA Institute Global Pension Index 2022.

It is important that the measures within YFYS continue to enhance our system and do not constrain the value of the benefits provided through restricting innovation, limiting investment options or providing misleading information to consumers.

The performance test has already succeeded in its objectives of lowering fees and driving consolidation for those funds determined to be underperforming. However, the longer-term consequences, which we highlight below, may be less favourable and result in lower overall returns for members.

We have already seen clear evidence that funds are managing to the test. Whilst in year one of the MySuper test, 13 funds failed the test only one new failure occurred this year (and that was a replica investment strategy to one of the previous 13). If no funds fail the test in future, will this be seen as a success (i.e. removing poorly performing funds) or, more realistically, acknowledging that if all continue to pass then something else has been given up to achieve this outcome. The part given up is better outcomes for members.

We believe a pathway towards a more balanced rectification process and period for those failing the performance test needs to be introduced over time to avoid members wearing the costs for a stringent system introduced to remove long-term underperforming funds that has now broadly achieved its goal. There are many facets to the success and sustainability of funds as highlighted in Margaret Cole's recent address to the Standing Committee on Economics. A more balanced outcome that enables funds to

pursue and deliver better overall outcomes for members should be the goal, if the YFYS reforms are to be seen as a success in the longer term.

We will explain our concerns in respect of these matters as respond to the particular questions in the Consultation Paper below. However, before we get into the detail, we think it is appropriate to make some opening remarks in respect of the performance test.

## Opening remarks

As you are aware, the current performance test is based on Recommendation 4 of the Productivity Commission's Inquiry Report from December 2018, which was:

> "The Australian Government should legislate to require all APRA-regulated superannuation funds to undertake annual outcomes tests for their MySuper and choice offerings. These outcomes tests should include:
>
> • a requirement for funds to obtain independent verification, to an audit-level standard, of their outcomes test determination, at least every three years (starting with the first test)
>
> • clear benchmarking requirements for all MySuper and choice investment options."

In respect of this recommendation, several points are worth making:

- The PC's recommendations were part of a package of recommendations, many of which have not been implemented. Hence, the consequences of this test may be quite different from that envisaged by the PC. Further, some of the features of YFYS were not recommendations from the PC.
- This recommendation also suggested a 12-month period of remediation for options that fall short of the benchmark. This concept has not been introduced as part of YFYS and has been replaced with a blunt pass/fail measure with no realistic period of remediation, given seven of the eight years remain the same. As discussed below, this approach has led to adverse consequences for members.
- The PC's Recommendation 4 went much further in terms of consequences than any of the draft recommendations in the PC's draft report of April 2018. Hence, there was no effective industry consideration or consultation in respect of this Recommendation. It is therefore not surprising that there are several unintended consequences of YFYS, as many of the implications of the performance test had not been thoroughly considered prior to its introduction.

It is also worth noting that the PC report correctly distinguishes between MySuper and Choice products. For example, it notes that:

> "At the time the authorisation process for MySuper products was introduced, it was intended to set strong safeguards to protect disengaged default members". (p 586)

We agree. Many MySuper members make no decision about their superannuation and therefore should receive protection within a compulsory superannuation system. Furthermore, MySuper products:

- have their own section of the SIS Act (part 2C)
- were designed to be a simple low cost balanced product which is different from many Choice products
- are a default product for individuals who do not make a choice. Of course, we also recognise that some members may choose MySuper due to its low cost and other features
- are deliberately supported by legislation which sets out some requirements, including:
  - having some common characteristics as set out in section 29R(1) of the SIS Act. Such requirements do not exist for Choice products. These characteristics include
    - A single diversified investment strategy (lifecycle based on age is permitted)
    - All members are entitled to the same benefit options and facilities except for risk insurance
    - Fees may only be charged for particular reasons as set out in section 29V(1)
  - That APRA has to grant authority for a fund to offer a MySuper product.

Therefore, given the required characteristics as set out in legislation and that it is the only default product available, it is reasonable to compare these products and test them against the legislated requirements. These requirements do not apply to Choice products.

Returning to the PC Report, Figure 13.2 (p588) sets out the elements that the “MySuper elevated outcomes test” should cover. These are:

- Administration
- Member services
- Insurance
- Advice
- Investment strategy
- Scale

Yet, the current performance test only considers investment performance and administration fees. As such, it does not reach the ideals set out by the PC Review.

The Treasury’s recent consultation paper referenced that the PC review recommended the need for measures “in light of muted demand-side pressure in the superannuation market.”

We accept there is muted demand in respect of MySuper products as they represent the default product for many fund members. Hence, some protection for these members is appropriate.

However, we question the suggestion that there is “muted demand-side pressure” in the Choice sector where many superannuation fund members make deliberate choices taking into account, a range of factors, including:

- Their personal principles, such as ESG preferences or ethical values
- Their risk profile, relating to volatility and the probability of loss
- Their other assets, outside superannuation
- Their cash flow requirements, particularly as they approach retirement
- The receipt of financial advice

For example, within the Mercer Superannuation Trust,

- 42.9% of corporate division members (i.e. where the members are employed by particular employers) who are not in MySuper (default life cycle) have their super in more than one option.
- 65.0% of retail members (i.e. where individuals have selected Mercer or remain in the fund after leaving an employer) who are not in MySuper (default life cycle) have their super in more than one option.

That is, these members do not have all their money in a single investment option. Rather, they have made deliberate decisions consistent with their personal situation and preferences, sometimes supported by financial advice. This does not suggest muted demand; rather, it is evidence that many individuals are looking for a range of options from their superannuation fund.

Finally, we suggest that the operation and consequences of the performance test should be consistent with other government policies. There are many but the following three highlight how the performance test could generate outcomes that run counter to the Government's policies:

1. The Retirement Income Covenant commenced on 1 July 2022 with the requirement for APRA-regulated funds to publish a retirement income strategy on their websites from that date. However, the development of a broader range of retirement income policies has just begun and it would be premature to introduce a test on these products at this stage. As the Treasurer recently said, there is currently "a lack of appetite for retirement income products." We agree, and it would be unfortunate if the extension of the performance test led to restricted innovation and development in this evolving area.

2. There is a clear intention from the Government to work with the superannuation industry to generate investment opportunities in a range of areas for the longer-term benefit of Australian society including housing, energy and infrastructure. It is important that the performance test and the benchmarks chosen do not inhibit or restrict such developments.

3. The Government has a very clear policy to reduce emissions in the short-medium term. This direction is also consistent with the desires of many super fund members and the growing demand for ESG-related investment options. Yet as the current benchmarks do not reflect this future, they may cause fund trustees to invest in carbon-related industries, which do not reflect the objectives of the government or some fund members.

We will elaborate on some of the above issues in our responses to the questions below.

## Performance test

Q1 Does the measurement of *actual return* using strategic asset allocation affect risk-taking behaviour by superannuation trustees?

Yes it does

*Why?*

The measurement of actual return using strategic asset allocation affects the investment decisions made by superannuation trustees and therefore the risks taken by the fund, simply because the consequences of failing the performance test are so dire for the Trustees. For instance, even failing the test once has created an expectation from the regulator that the affected fund will consider contingency options for future operations, including but not limited to a merger with another fund.

Due to these significant consequences, continuing to pass the performance test has become a primary objective for trustees. This inherently changes the governance and decision-making processes within funds as the previous focus on member outcomes (which are driven by risk-adjusted returns) must now be supplemented with considerations of the risks and implications of failing the performance test.

In practice, our experience has been that most superannuation boards now receive regular information regarding the way a fund is tracking against the performance test. The results of this monitoring then determine the amount of risk a fund is willing to take in deviating from the passive benchmarks set out in the performance test.

*How?*

We consider that this has created three issues when making investment decisions:

1. Issues relating to the risk taken at the asset allocation level

Super funds manage total portfolio risk by allocating investments to a range of asset classes that offer complementary characteristics and hence provide diversification benefits. For instance, two complementary asset classes may be expected to achieve strong returns at different times in an economic cycle.

Despite the wide range of asset classes used by funds, the current performance test provides a limited number of benchmarks. This means that many funds invest in assets that do not have a relevant benchmark within the performance test. The effect if that if a super fund invests in an asset class that is expected to behave differently from the benchmark against which it is being measured, then the super fund needs to consider the extent of the “tracking error” risk it is taking, relative to the prescribed benchmark. In some cases, the tracking error risk is considered too great a risk to take, resulting in a portfolio that is less diversified (i.e. it has a higher overall portfolio risk) than would be the case without the performance test.

The following worked example illustrates this impact. Using Mercer's proprietary capital markets simulator we have analysed the expected risk and return from two portfolios over the next ten years. The first portfolio (the 'Original Portfolio) represents a well-diversified portfolio with an allocation of 30% to growth assets and 70% allocated to defensive assets. The second portfolio has exactly the same starting asset allocation but assumes that the portfolio is invested according to the benchmarks nominated in the performance test (the 'PT' Portfolio) and is therefore less diversified. The results show that the PT portfolio provides a lower level of expected return and a higher level of expected risk (through less diversification) than the original portfolio.

*Portfolio analysis of Original Portfolio and PT Portfolio for a Portfolio with a 30% allocation to growth*

| Portfolio metric | 'Original' Portfolio | 'PT' Portfolio |
|---|---|---|
| Expected Return | 3.7% | 3.2% |
| Standard Deviation | 3.9% | 4.1% |
| Number of Negative Years in 20 | 2.3 | 2.4 |
| Probability of meeting inflation related Objective | 60.0% | 55.4% |

This example shows that member outcomes are negatively impacted by the resulting change in portfolio construction that follows the performance test.

The next table shows the results for a 70/30 portfolio.

*Portfolio analysis of Original Portfolio and PT Portfolio for a Portfolio with a 70% allocation to growth*

| Portfolio metric | 'Original' Portfolio | 'PT' Portfolio |
|---|---|---|
| Expected Return | 6.2% | 5.4% |
| Standard Deviation | 8.9% | 8.5% |
| Number of Negative Years in 20 | 3.9 | 4.0 |
| Probability of meeting inflation related Objective | 60.1% | 52.4% |

2. Issues relating to the risk taken based on a changed time horizon

Investment literature indicates that an investor's investment horizon is a key determinant of an optimal asset allocation[1]. Longer investment horizons allow super funds to 'spread' the volatility of uncertain investments over a larger timeframe and thereby increase portfolio allocations to riskier assets that may require a longer period to provide a benefit to members

The performance test is measured as at 30 June each year over rolling eight-year periods. A rolling test by its nature means that at each 30 June the eight-year performance of a fund will

[1] Warren, G.J, "How Investment Risk Evolves with Horizon", ANU Working Paper, September 2018

change from the prior year by including the latest twelve-month period and omitting the first twelve-month period that was previously included.

Hence, the performance in the omitted twelve-month period directly impacts on the performance required in the new twelve-month period to pass the test.

In some cases, this will result in super funds making investment decisions restricted to a twelve-month time horizon. This is a very short horizon and is materially shorter than is normally appropriate for super funds. This effect may be particularly relevant in some years after a significant market event, such as the global financial crisis.

3. Issues relating to the risk taken at the investment selection level

   In constructing asset class portfolios, super funds generally blend a range of investment styles (such as value and growth in the equities market) to ensure that, in combination, the portfolio has the highest likelihood of outperforming throughout a market cycle. However, the significant consequence of failing the performance test means that in constructing these portfolios, some funds will seek to minimise the tracking error of these portfolios against the YFYS benchmark rather than to optimise long-term investment outcomes. This may result in performance that is less robust and less diversified than it may otherwise have been.

Q2 Does the current set of indices used to calculate *benchmark returns* unintentionally distort investment decisions or reduce choice for members? If so, is there a way to adjust the benchmark indices while maintaining a clear and objective performance test?

Yes, we refer to our response to question 1 on why any performance test that uses a set of indices will impact investment decision making. As Peter Drucker is quoted as saying:

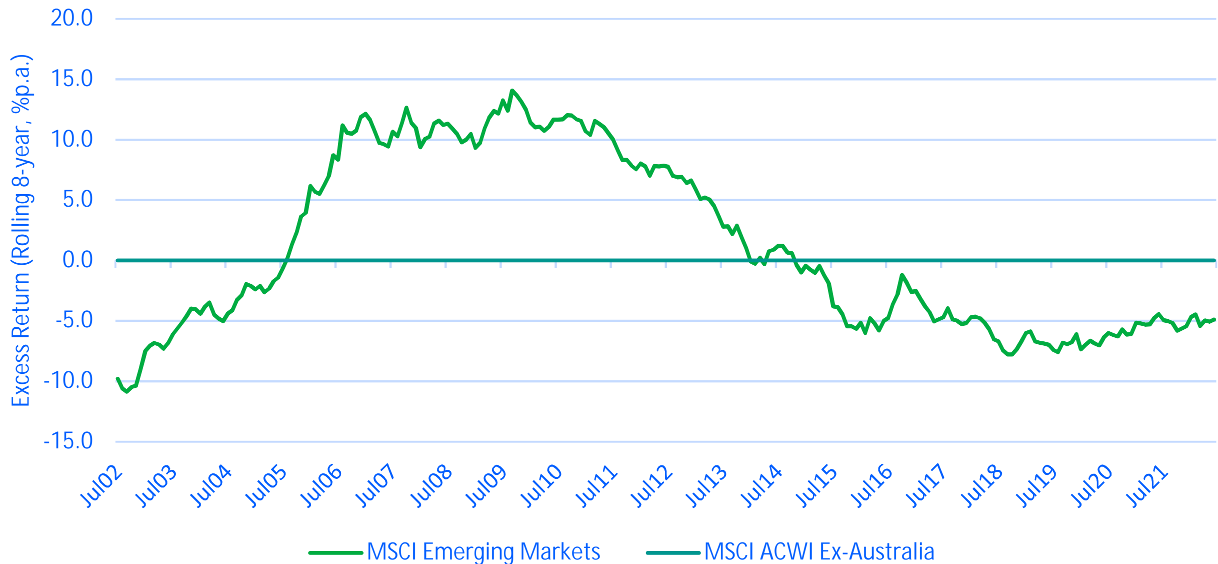
> "What gets measured, gets managed."

Beyond these direct impacts, we expect that there will be a further impact on decision making due to the specific indices that are prescribed within any test.

We believe the use of the current set of benchmark indices leaves several areas where the asset classes used by Australian superannuation funds do not have an appropriate benchmark. This includes Emerging Market Equities (which are currently benchmarked to International Equities) and International Unlisted Property and Infrastructure (which are both benchmarked to Australian indices).

The following figure illustrates this impact by charting the rolling 8-year excess return of the MSCI Emerging Market Index relative to its benchmark under the Performance Test (namely the MSCI All Country World EX-Australian Index). It reflects that the choice to adopt an investment allocation to emerging markets has material implications for a fund in the performance test.

***Rolling 8-year excess return MSCI Emerging Markets Index relative to MSCI All Country World Ex-Australia Index***




On balance this means that the current set of benchmarks impose a penalty on funds that choose to use the asset classes which are linked to an inappropriate benchmark in the performance test. This has the effect of reducing the range of asset classes that funds can freely use in portfolio construction to those asset classes that are specified in the benchmarking of the performance test. The consequence of this reduced breadth is reduced portfolio diversification and increased total portfolio risk.

We therefore recommend that the set of benchmark indices that are currently used in the performance test be supplemented to introduce benchmarks to help address asset classes where the current benchmark is not appropriate. In responding to this current shortcoming in the test, it will be critical to ensure that the benchmark selected for each new asset class appropriately captures the typical exposures that are included within those asset classes in Australian superannuation fund portfolios.

At a minimum, we recommend the addition of benchmarks in respect of:

- Emerging Market Equities.
- International benchmarks for both Unlisted Property and Unlisted Infrastructure.
- Short Duration Bonds (Australian and International).
- Alternative Defensive and Alternative Growth portfolios

The inclusion of a broader range of benchmarks becomes even more important if the performance test is extended to a broad range of choice options.

The table below sets out suggested changes to the benchmarks used in the performance test.

| Asset Class | Current Benchmark | Proposed Benchmark |
|---|---|---|
| **International Equity (unhedged)** | MSCI ACWI ex Australia with Special Tax (unhedged in AUD) | MSCI World Index (ex Australia) in $A with net dividends reinvested |
| **Emerging Market Equities** | MSCI ACWI ex Australia with Special Tax (unhedged in AUD) | MSCI Emerging Markets Index in $A (unhedged) |
| **International Unlisted Property** | MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index – NAV – Weighted Post Fee Total Return (All Funds) | Either the INREV Global Real Estate Fund Index (GREFI) or the MSCI Global Property Fund Index |
| **International Unlisted Infrastructure** | FTSE Developed Core Infrastructure 100% Hedged to AUD Net Tax (Super) Index | EDHEC - infra300@ (quarterly), EW LCU. Bloomberg Ticker = INFRA300 |
| **Shorter Duration Australian Fixed Interest** | Bloomberg Ausbond Composite 0+ Yr Index | Bloomberg Ausbond Composite 0-3 years Index |
| **Shorter Duration International Fixed Interest** | Bloomberg Barclays Global Aggregate Index (hedged to AUD) | Bloomberg Barclays Global Aggregate (1-3 years) Index (hedged to AUD) |
| **Alternative Defensive** | 25% International Equity (hedged)<br>25% International Equity (unhedged)<br>50% International fixed interest | Cash plus 2% (after investment fees) |
| **Alternative Growth** | 25% International Equity (hedged)<br>25% International Equity (unhedged)<br>50% International fixed interest | Cash plus 4% (after investment fees) |

We acknowledge that the introduction of additional asset classes and additional benchmarks will require each of the new asset classes to be clearly defined.

Q3 Does the calculation of *actual RAFE* and *benchmark RAFE* discourage non-performance related product features that members may value (such as customer service or platform products)? If so, can this be addressed without diminishing the test's focus on performance?

This question is answered in two parts – MySuper products and Choice products, for the reasons outlined in our Opening Remarks.

MySuper products are designed to be low cost simple products, which can be compared relatively simply. Hence, we believe the current approach, using fees and expenses for the last twelve months, represents a valid component of the performance test. That is, the fees and expenses for the last twelve months provide a reasonable representation of the fees that will be charged to members in the coming 12-month period. This also appears to have been a success of YFYS to reduce administration fees. The use of the 12-month rolling period and the known immediate impact this has on the test outcome will continue to drive improved fee outcomes for members.

However, in respect of Choice products and as outlined in the PC's elevated test proposal, we believe it is appropriate to adopt a more holistic perspective and take into account the broader range of services available to members. Without such an approach, there is a danger that funds will reduce or remove some of these services to reduce their costs and the subsequent fees charged to members.

It is also worth noting that the Retirement Income Covenant requires funds to assist members who are approaching or in retirement. Again, a tension is present between the objective of the Covenant and the use of RAFE, if it solely concentrates on fees and not the services provided.

Q4 What are the longer-term impacts of the performance test on market dynamics and composition? How will these factors impact on long-term member outcomes?

We expect the longer-term impacts of the performance test will be to alter the number of funds operating in the market and the range of portfolios that these funds offer to members.

That is, application of the performance test will lead to an increased number of fund closures due to the severe penalty, which applies to funds that fail the test. This has been evident following the first application of the MySuper test and will, by definition, lead to a reduction in the number of superannuation funds operating in the market. The test is also likely to dissuade international players from entering and/or investing in the market due to the damage that failure could have on their international brand.

Hence, we believe this will lead to a superannuation industry where there are fewer funds with most market participants holding at least $30 billion in funds under management.

In terms of the portfolios offered to fund members, we expect that the longer-term impact of the performance test will be to reduce portfolio diversification, which may lead to more variable returns to all members. This may be particularly significant for members approaching and in retirement.

In addition, fund trustees are likely to focus increasingly on the same limited number of prescribed benchmarks. This may lead to a "herd mentality" and capacity constraints as funds compete for the limited opportunities available in the asset classes specified in the performance test. Further, this is likely to lead to increased homogeneity of investment strategies across the industry and rising systemic risk.

A further, seemingly unintended, consequence has been the latest interpretation and approach taken by APRA towards stitching investment performance. This has been extended recently to certain situations where there has been a change in Trustee and investment management despite this being the outcome desired by YFYS. By deciding to stitch historical performance this will deter a fund's ability and willingness to accept funds that have previously underperformed. This will either leave members stuck in underperforming funds or placed into alternative arrangements which lead to higher fees even though the underlying investment strategy is the same.

Q5 Is there evidence to indicate that the notification and website publication requirements have been effective at encouraging members to consider, and switch to, alternative products? Are there ways this could be improved?

The current required letter is understandably generic and therefore not specific to each member's situation. As such, it does not engage with each individual. It may also represent poor advice for some members, as there is no mention of insurance, which represents an important benefit. For example, some members select a MySuper product for access to insurance and may have most of their super investments elsewhere.

Of course, the performance assessment also relates to eight years of past performance that may not reflect the performance that the individual has actually received if s/he joined the fund more recently.

In addition, and as ASIC notes in RG53:

> "information about past performance has a greater risk of being misleading if it is presented:
>
> (a) in a manner that implies it constitutes a projection illustrating the likely future value of an investment; or
>
> (b) in a way that creates the impression that substantially the same returns will be achieved in the future.

While this warning does not imply that the performance tests should not continue or that underperforming funds should not be identified; it is appropriate to recognise that the past performance (good or bad) will not necessarily be repeated in the future.

Q6 Have the consequences been effective at encouraging trustees to improve their performance or merge with better performing funds? Are there ways this could be improved?

We believe that the severe consequences of failing the performance test have been effective at encouraging trustees to merge with better performing funds where a failure is likely or certain. However, we do not consider the consequences (and the construct of the test) to be effective in affording trustees an incentive to improve their performance.

There is no doubt that the significant consequences of failing the test for MySuper products has encouraged trustees to modify their investment strategies. However, as indicated in our answers to Question 1, this action may have actually reduced long-term investment returns to members.

We believe these significant consequences need to be modified in respect of Choice products as outlined in our recommendations which follows our response to Question 9.

Q7 Are the measures in place to resolve underperformance sufficient given the potential for members to be stapled to these products? How can the system best support members in underperforming products?

The measures in place to resolve underperformance go beyond YFYS requirements. For example, there are two APRA prudential standards relevant to resolving these issues. They are:

- SPS515 Strategic Planning and Member Outcomes
- SPS530 Investment Governance

It is also worth noting that SPS 515 and the APRA heat maps did not exist when the PC carried out their review.

We believe that these two standards, together with the other tools at APRA's disposal including the heat maps, are sufficient to resolve underperformance issues.

A relatively simple development to support members in underperforming products would be to extend the Capital Gains Tax (CGT) relief from successor funds transfers to transfers of individual products within a particular superannuation fund. That is, it seems unreasonable that CGT relief applies if all the assets of one super fund are transferred to another fund but such relief does not apply if the trustees wish to simplify their offering by transferring all the assets of one investment option (and thereby closing it) into another product within the same fund.

Q8 Are there any significant issues to be expected when the test is extended to TDPs? If so, how could these issues be addressed?

Yes, we believe there will be very significant issues if the test is extended to TDPs.

Choice investment menus seek to provide members with access to investment products, which are distinct from those provided through the MySuper default. This leads to a much broader range of investment strategies and styles available within Choice menus, which in turn amplifies the likelihood that the benchmarks adopted for MySuper products are inappropriate. This is true for multi-sector diversified portfolios (TDPs), which can have specific (and intentional) tilts, but is magnified even further for single sector (or sub-sector) products, such as:

i. Specialist strategies – low volatility equities, value/growth style, specific country/region equities;

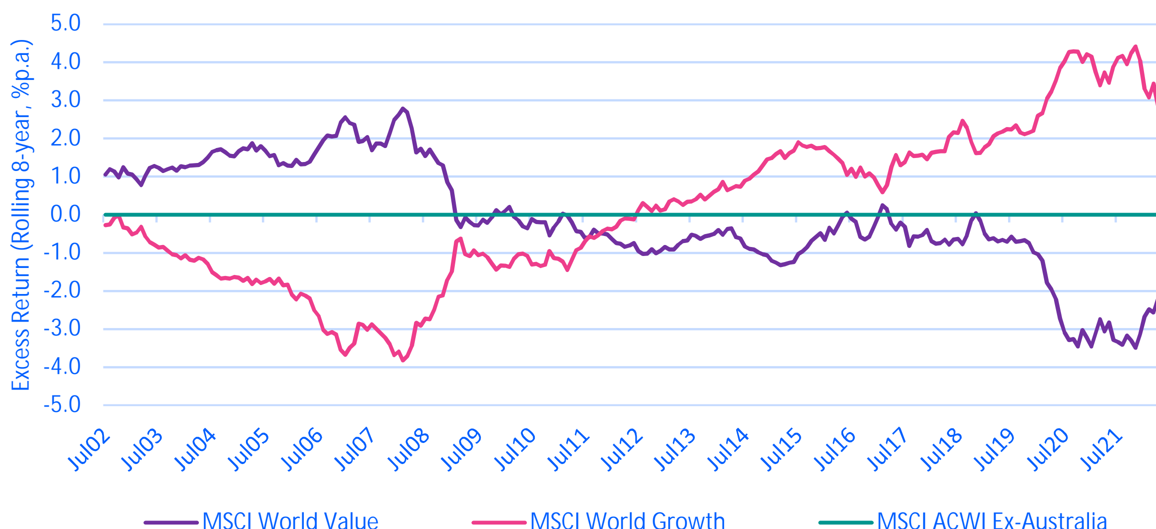
ii. Unlisted investment strategies – for which benchmarks are highly unlikely to be appropriate as often practically impossible to invest in line with the make-up of an unlisted benchmark; and

iii. Protected equity strategies – which are commonly bespoke and do not have a natural benchmark.

The next graph illustrates this by showing the historic index returns of two specialist strategies against the benchmark. It shows that over rolling eight-year periods significant deviations in performance versus the benchmark exist and that certain strategies that underperform in some economic conditions may return to outperformance later.

This chart illustrates that over rolling eight-year periods, both the MSCI World Value and Growth Indexes have suffered from periods of underperformance versus the MSCI ACWI ex-Australia Index by more than 3% pa. Yet, both have also shown periods of outperformance.

***Growth and value indices relative to the MSCI ACWI (rolling 8-year excess)***




Should the performance test be extended to specialist offerings, some funds will close some specialist options where there has been historical underperformance even where the internal view is that the option will return to outperformance, if given time.

In the event that a performance test for Choice options is implemented, we expect there is potential for funds to end up with holes, or gaps, in their product suite. For example, if a fund was unfortunate enough to select fixed interest managers that significantly underperformed the performance test benchmark, this could see all of the fund's more conservative multi-asset class investment options fail the performance test. In this case and under the current requirements, it would need to close those options and thereby reduce its product suite. That could leave the fund with only aggressive, high-risk options for members to choose from and potentially force them to select an investment option that has a higher level of risk than they desired. Similarly, it could see members looking to alternative channels, such as, SMSFs to access this range of investment options, which may not be appropriate for them. Therefore, as will be recommended below, we believe the consequences of a Choice product failing the performance test should be different from a MySuper product failing the test.

We expect that it would be challenging to address these issues without compromising the objective to assess performance using a uniform, clear and objective test. For instance, we do not expect that it is feasible to add enough new benchmarks to ensure that there are appropriate benchmarks for every Choice investment strategy and for APRA to collect the necessary data to enable it to apply the performance test in an equitable manner.

Q9 What would be the impact of extending the current performance test to other Choice products (such as single sector or retirement products)? How could any issues be addressed?

If the YFYS performance test is extended to other Choice products then the construct of the test is likely to reduce the number of investment options available to members. That is, superannuation funds are unlikely to offer an investment option where its investment performance will be measured against an "inappropriate" benchmark or where there is a real risk of the product failing the test. We expect that most funds would choose to remove options that are at higher risk of failure from their menu to avoid potential reputational damage from failing the test. Some funds have already done this in the lead up to the expected implementation date of 30 June 2022.

In addition, we do not support extending the performance test to retirement products. The Retirement Income Covenant was legislated in February 2022 and APRA-regulated funds were required to publish their retirement income strategies from 1 July 2022. Hence, retirement products are currently being developed throughout the industry and the imposition of the test would restrict innovation and the development of new products.

Furthermore, it must be recognised that retirees are a heterogeneous group with a much broader range of needs and desires than those in active employment. It would therefore be totally inappropriate to introduce a single implementation-based performance test on a range of products that encompass several features including investment performance, longevity protection, market volatility protection, capital preservation and financial advice. On the other hand, the extension of APRA's heat maps to these products could provide some additional insights to APRA and fund trustees.

**Recommendations relating to the performance test**

Mercer recommends that the investment performance test needs to be reviewed before it is extended to some (or all) Choice products within the superannuation sector. However before setting out our recommendations, we note that the performance tests have four different features, each of which can have unintended consequences. These features are

1. The calculation of the test – this includes the look back period, the benchmarks used and the margin or buffer permitted beneath the benchmark.
2. The presentation of the results – currently this is pass/fail approach with no margin for error. An alternative approach would be some form of traffic light or colour coding, as used in the APRA heat maps.
3. The consequence of the results – the current consequences are very significant such that "passing the test" has become the number one objective for many fund trustees.
4. The communication of the results to the media and members – the current required communication to members upon a failure is not easily understood by most members and is therefore ignored by many. Similarly, the binary messaging to media (i.e. pass or fail and nothing in between) means that the consequences of failure are significant and therefore a priority to avoid, if possible. Similarly, the communication through the ATO website is often unhelpful and does not tell the full story, as discussed in our comments prior to Question 10.

Therefore, in the light of our earlier comments, Mercer recommends the following three forms of performance tests:

- ***My Super tests -*** the continuation of the existing test for MySuper products although the benchmarks should be improved to better reflect actual investments in the following areas:
  - Emerging Market Equities
  - International benchmarks for both Unlisted Property and Unlisted Infrastructure
  - Short Duration Bonds (Australian and International)
  - Alternative Defensive and Alternative Growth
- ***Trustee Directed Products*** – The extension of the current tests should be limited to portfolios (or Choice products) where there are at least four broad asset classes (excluding cash) within the portfolio. This restriction (or tighter definition) of TDPs also reduces some of the unintended consequences where appropriate benchmarks are difficult to find due to the diversified nature of some asset classes.

  However, the consequence of failing the test twice should not be to remove this option from the portfolios available to new members, as this would also disadvantage members who seek to invest in a range of portfolios. Rather, APRA should be required to work with the fund to ensure that performance is improved in the future years, through appropriate warnings and required remediation.
- ***All other investment options*** – These investment options should be subject to the existing APRA heat map process and underperforming investment options would be subject to APRA's ongoing monitoring through SPS 515. The reason is simple. The application of the performance test to every investment option will reduce innovation and reduce competition in the market.

Mercer also recommends that:

- The look back period to calculate the net investment return be gradually extended to ten years to provide a slightly longer investment period and to provide consistency with other measures such as a the MySuper dash board. We expect that this would be most efficiently achieved through gradually extending the test period to 9 years and then 10 years. However, the extension of the period also means that serious consideration should be given to an additional test reflecting the results for the more recent years, which could show significant improvement.
- The period for the actual RAFE should be maintained as the representative fees and expenses for the latest financial year but that rebates should not be included this calculation. This approach will continue the current pressure to reduce fees charged to members.

- Treasury and the industry work together with APRA to introduce a more balanced and appropriate mechanism aligned with the heat maps to determine underperforming products and the consequences of failing the test. This should include the introduction of a risk factor into the calculation of the performance test to encourage trustees to pursue optimal higher returns rather than minimising the likelihood of failing the test. The attachment to this submission sets out a relatively simple way of introducing a risk-adjusted performance test.

## YourSuper comparison tool

Mercer has several concerns with the YourSuper comparison tool, which limits its effectiveness, and the promotion of better outcomes for individuals. Of course, we recognise the desire for a relatively simple tool that can be used on a range of devices but believe that the following shortcomings limit its usefulness.

1. The default ranking in the comparison tool is by annual fees and not net return. As the net return includes an allowance for fees, we consider a default ranking by net returns would be more consistent with member outcomes than using fees.
2. Many MySuper products offer a life cycle approach recognising that many members wish to de-risk their portfolio as they approach retirement. Yet the website does not clearly explain why some MySuper products show a single net return whereas other show a range of returns.
3. MySuper products are required to offer insurance cover for most members. The relevant premium rates for cover of say $100,000 can vary significantly, yet the tool shows no comparison of these rates. Indeed, for some members, the insurance costs can be higher than the annual fee shown.
4. The disclaimer, assuming an individual clicks on it, states that the information is general information only and does not take into account the individual's financial situation or retirement objectives. Yet, this disclaimer makes no mention that
   a. The investment risks taken by the trustees of each MySuper product are not the same;
   b. Past performance is no guarantee of future performance; and
   c. The fees charged to an individual may be less than those shown due to arrangements organised between the super fund and the employer.

These shortcomings need to be addressed to improve the relevance and effectiveness of the tool.

Q10 Does the comparison tool adequately inform members and prompt a behavioural response? Is the tool effective at informing new employees of their options when entering the workforce, including those who do not have an existing superannuation account?

Yes, but only in certain circumstances. Although many Australians have accessed the website, it is difficult to know how the tool has encouraged appropriate behaviour. In fact, for the reasons outlined above, it may have also encouraged inappropriate behaviour with some members opting for a higher annual fee, as they may be unaware of their employer's discount, insurance that is

more expensive, or misunderstanding the meaning of the range of investment returns shown for a particular product.

Most employees entering the workforce are under the age of 21, often in a part time or casual role, and superannuation or retirement is a distant dream. In these circumstances, we do not believe that most of these young individuals have any interest in choosing a super fund. The removal of the $450 threshold for SG purposes will increase the number of younger new entrants.

As individuals mature and many move into full time employment, interest in superannuation gradually increases. In these circumstances, the comparison tool can be useful. However, it's also worth noting that many members of this generation have an increased awareness of where their superannuation contributions are invested due to an increased environmental awareness. Understandably, the comparison tool does not consider these issues.

Q11 To what extent would altered or additional metrics, or improved functionality, make the tool more effective while ensuring it remains simple and clear? What more can be done to ensure that new employees are able to choose high-performing superannuation product that are appropriate for their needs?

As outlined above, Mercer recommends the introduction of additional metrics, particularly in respect of an investment risk measure and insurance. In addition, the introduction of some clear wording relating to the uncertainty of future investment returns notwithstanding past performance.

Q12 As the test is applied to more superannuation products, should the comparison tool also be extended? Considering the volume and complexity of Choice products, how could the tool be extended in a way that is meaningful and digestible to members?

At this stage, Mercer strongly recommends that the tool is <u>not</u> extended to more superannuation products for three primary reasons:

1. the current YourSuper comparison tool has limitations and needs to be improved before any extension is considered;
2. the variety of Choice products, ranging from diversified portfolios to single specialist options, would make the development of a practical and meaningful comparison tool almost impossible; and
3. some Choice products are unsuitable for some individuals. For example, a high-risk, specialised option may have performed very well during the look back period but there is a real risk that such outperformance will not continue.

As noted earlier, there is a fundamental difference between MySuper and Choice products and this must be recognised and clearly shown in respect of any comparison tool as well.

**Recommendations relating to the YourSuper comparison tool**

Mercer recommends that the YourSuper comparison be improved significantly before it is extended to other superannuation products. These improvements should include:

- changing the initial ranking to concentrate on net outcomes, not fees
- introducing clear disclaimers relating to past and future performance
- showing some measure relating to portfolio risk
- adding the cost of basic insurance to the comparison tool
- explaining the range of returns shown for life cycle products

## Stapling

Q14 To what extent are employers putting into practice processes to seek stapled fund details from the ATO? How has the implementation of stapling changed onboarding, software and payroll processes for new employees?

The initial ATO non-digital process for employers in respect of stapling has not been efficient for many employers. Hence, some major employers have continued their previous process of offering new employees Choice of Fund forms. In some cases, this means the new employee joins the employer-chosen fund, which may have insurance or other features that are particularly suitable for that employer's workforce, such as employer-subsidised fees or insurance.

Although this outcome may not appear to be consistent with some of the objectives of YFYS, such outcomes can offer better value for these employees than remaining in their previous super fund.

Q15 Are there any barriers in the current framework to achieve the intent of the stapling reform?

The introduction of fund stapling should reduce the number of member accounts within the Australian superannuation system and that is a desirable outcome. Therefore, Mercer supports the continuation of the stapling framework.

However, it is also important that employees continue to have choice in respect of the superannuation fund that receives their SG contributions, whether that be their previous fund, an employer-chosen fund or an SMSF.

Q16 What is the actual, or likely, impact of stapling on insurance coverage?

The first thing to note is that this will be a very gradual impact, in contrast to the earlier changes to group insurance relating to PYS/PMIF. That is because many individuals will remain in their previous super fund due to stapling, even when they change jobs.

Second, some super funds have insurance arrangements with certain exclusions for high-risk occupations. Hence, if an individual moves to a higher-risk job but remains with their previous fund, they could lose their insurance coverage. However, the FSC's recent Enforceable Standard, which takes effect from 1 January 2023, should reduce this impact in respect of *default* insurance cover.

Nevertheless, some individuals who have previously opted for increased levels of insurance cover may still feel this impact.

Third, the inclusion of higher risk occupations in some insurance arrangements, where they were previously excluded, is likely to increase premiums or reduce Automatic Acceptance Limits in some group life insurance arrangements over the longer term. This impact of stapling also means that membership of most superannuation funds will become more diverse over time and less homogenous in terms of industry, employer, occupation or background. This development is likely to make the design and pricing of group insurance more complex and costly.

## Best financial interests duty

Q17 To what extent has the BFID required trustees to change their processes and procedures? Has this caused any unintended consequences or impacted member outcomes in any way?

BFID has certainly introduced a significant layer of administration around approval of expenditure and record keeping, particularly because of the reverse onus of proof and the need to maintain a strong paper trail for every individual item of expenditure, regardless of the amount. This is not an efficient process.

It has required trustees to document and justify every category of expenditure, irrespective of its nature (operational, discretionary or otherwise) and materiality. This increases the compliance and regulatory costs without any obvious benefits for member outcomes given that under the existing statutory covenants all fund expenditure was required to be justifiable as being appropriate and prudent, acting in the best interests of members and having regard to the sole purpose test.

Q18 Are there certain types of expenditure or activity that trustees are particularly concerned about being able to prove compliance with the BFID in respect of? Why is it difficult to demonstrate compliance? Should there be a materiality threshold?

BFID combined with a reverse onus of proof has elevated the compliance and governance trail required for every expenditure decision.

Introducing a materiality threshold would certainly help with this issue and allow trustees to put in place an appropriate risk-based approach to approving and monitoring expenditure.

Q19 Is the reverse onus of proof the most appropriate way to achieve the objective of improving member outcomes?

Mercer does not believe that the reverse onus of proof should apply in respect of civil matters. Given the powers and tools already available to APRA, the reverse onus of proof is not necessary to improve member outcomes.

**Recommendations relating to BFID**

Mercer recommends

- Introducing a materiality threshold in respect of items of expenditure, and
- Removing the reverse onus of proof.

## Concluding remarks

The introduction of Your Future, Your Super represented a key development in the ongoing improvement of Australia's superannuation system. It has already had a significant impact that has, in part, delivered better member outcomes to Australian superannuation fund members. Mercer welcomes this result.

However, further developments must ensure that the effects are not such that long-term investment returns are reduced or innovation discouraged. We therefore urge the Government to be careful of further unintended consequences as YFYS is reviewed and decisions are made.

Naturally, we would be very happy to discuss any of the above comments with you and your team as you carefully consider these matters. Please not hesitate to contact us.

Yours sincerely,

**Dr David Knox**
**Senior Partner**

**Attachment**

## The proposed return-risk investment performance test

The current performance measure is:

(Actual Return – Benchmark Return) + (Benchmark RAFE – Actual RAFE)

As noted in our submission, the investment return aspect of this measure makes no allowance for the risks associated with the superannuation product's investments.

Mercer therefore proposes a second measure relating to the investment aspect of the measure, taking into account both investment return and risk, along the following lines:

$$\frac{\text{(Actual Return – Benchmark Return)}}{\text{Benchmark Return}} \quad \text{minus} \quad \frac{\text{(Portfolio Risk – Benchmark Risk)}}{\text{Benchmark Risk}}$$

The logic is that we are testing whether the level of underperformance in the current test is more than compensated by the lower risk (or volatility) taken to achieve this return.

Risk would be calculated as the standard deviation of the actual portfolio or the benchmark portfolio, which is common practice within the investment industry.

In the following example, we consider a product that would fail the current performance test but should not be considered underperforming due to their reduced risk.

*Example*

Let's assume the following

- Net Investment return of the actual portfolio — 6.0% pa for the last 8 years
- Investment return of the benchmark portfolio — 7.0% pa for the last 8 years
- Standard deviation of the actual portfolio — 9% for the last 8 years
- Standard deviation of the benchmark portfolio — 12% for the last 8 years

Under the current performance test and ignoring the RAFE component, this product would fail the performance test as the Actual Return is 1.0% pa below the Benchmark return and hence the "loss" is greater than the 0.5% threshold.

However, under our proposed test, the calculation would be as follows:

$$\frac{0.06 - 0.07}{0.07} \quad \text{minus} \quad \frac{0.09 - 0.12}{0.12}$$

$$= \quad -0.143 \quad \text{minus} \quad -0.25 \quad = 0.107$$

Therefore, ignoring the RAFE component, this product should pass the test because the lower return has been more than offset by a lower risk and hence reduced volatility for the beneficiaries.

Conclusion

This simple example highlights the fact that the current performance test with a single investment metric is not sufficiently robust and is encouraging behaviour that is not always in the members' best financial interests.

The following charts highlight the difference between the current test and our suggested test.