3 May 2023

Director
Members Outcomes and Governance Branch
Retirement, Advice and Investment Division
Treasury
Langton Cres
Parkes ACT 2600

Via email: yfys@treasury.gov.au

Dear Sir/Madam

Superannuation Performance Test Regulations 2023 Exposure Draft ('the Exposure Draft')

Chartered Accountants Australia and New Zealand (CA ANZ) and CPA Australia welcome the opportunity to provide comments on the Exposure Draft.

CPA Australia and CA ANZ represent over 300,000 professional accountants globally. Our members work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally.

The Exposure Draft seeks to amend the testing period, benchmarks and notification letter relating to superannuation performance testing. Additional changes are proposed that seek to provide clarity, reduce the Australian Prudential Regulation Authority's (APRA's) administrative burden and ensure that the performance test is appropriate for trustee directed products.

We welcome the government's desire to improve these rules. However, we believe that following these amendments, significant problems will remain with the Your Future Your Super (YFYS) rules. This submission details our concerns.

For further information in relation to our submission, please contact Richard Webb, Policy Advisor Financial Planning and Superannuation at CPA Australia at richard.webb@cpaaustralia.com.au or Tony Negline, Superannuation and Financial Services Leader at CA ANZ at Tony.Negline@charteredaccountantsanz.com .

Yours sincerely

Tony Negline CA
Superannuation and Financial Services Leader,
Advocacy and Professional Standing,
Chartered Accountants Australia and New Zealand

Richard Webb
Senior Manager, Financial Planning and Superannuation
Policy PD, Policy and Advocacy
CPA Australia

Attachment

Submission

Introduction

CA ANZ and CPA Australia have participated in consultation at every stage of the implementation of the YFYS reforms. Whilst we generally supported the measures contained in the reforms – with the exception of the best financial interests' duty (BFID) – it was our opinion that the reforms required significant adjustment to be suitable for the purposes for which they were designed.

We raised concerns about references in the legislation to requirements 'in writing' which perpetuates problems identified in a related consultation undertaken by Treasury: *Modernising Business Communications* and *Additional Improvements to Corporations and Financial Services Law*.

CPA Australia and CA ANZ have previously noted the widespread use of the term 'in writing' in the *Superannuation Industry (Supervision) Act 1993* and its regulations and the need to provide greater flexibility in how communication must take place in the superannuation sector between all those involved – regulators, fund trustees, administrators, auditors and members.

We believe this was a missed opportunity for the *Treasury Laws Amendment (Your Future, Your Super) Act 2021* (the 'YFYS Act') to address this reform issue and unfortunately this remains unresolved.

Performance Test

10-year lookback period

The performance test works by assessing a product's net investment returns against an objective benchmark portfolio tailored to its investment strategy and assessing its administration fees against its peers. The benchmark portfolio is chosen by APRA from a series of indices[1] which are chosen depending on the strategic asset allocation of the fund. The assessment of administration fees is conducted relative to the median fee charged across the category.

As has been pointed out by a number of professional associations, the performance test focuses on the execution of an investment strategy not on the investment strategy itself. It is possible that an investment option may underperform in relation to the performance test but show strong relative performance on a net returns basis.

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[1] Refer Appendix B, APRA 2021. *MySuper Heatmap*. Methodology paper, December 2021. [online] Canberra: Australian Prudential Regulation Authority. Available at: https://tinyurl.com/e45p78bz [Accessed 28 April 2023].

It is hard to disagree with trustees being asked to justify why their fund's investment performance is below an acceptable standard and/or their fellow trustees in other superannuation funds. However, we remain concerned about unintended consequences with these periods of assessment. We believe that in some cases trustees may be willing to take on more investment risk in order to recover from poor investment periods and/or adjust their portfolios into more acceptable assessment benchmarks. In short, we are concerned about the system being gamed. We are already seeing evidence of this unfortunate aspect[2].

In any event, we consider that a twelve-year time period may be better for such assessments. Superannuation is a long-term investment, and we believe that this timeframe encompasses the vast majority of minimum recommended time horizons in place for most investment options.

Regardless of the period used, it also may be that some trustees could successfully argue that some actions are in their members' *best financial interests* but may not be able to argue that those actions are in those members' *best interests*.

Table of covered asset classes

We note and appreciate the additional benchmarks in the Exposure Draft Regulations that will enable disaggregation of "some covered asset classes", as explained in the Exposure Draft Explanatory Statement. In our previous submissions we asked that more benchmarks be included.

However, in many cases, the benchmarks chosen still do not resemble those used by trustees, asset consultants and investment managers in the construction of a product. Also, they are not useful to members in assessing the performance, or the appropriateness, of a product for retirement savings.

For example, the performance test requires the S&P/ASX 300 index to be used for a product which invests in Australian listed equities. This would be the case regardless of whether the product's investment strategy specifically considers this to be a relevant benchmark, or if the product's investment strategy allows (or requires) investment in assets outside of the S&P/ASX 300 index. Despite the stated aim of the Strategic Asset Allocation (SAA) benchmark portfolio used by APRA to assess implementation of trustees' 'investment strategies'[3], investment strategies exist which necessarily introduce tracking error, for example:

- Products requiring exposure to small cap companies may be more appropriately partially or fully benchmarked to the S&P/ASX Small Ordinaries index rather than the S&P/ASX 300 index.

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[2] Bell, D., 2022. *Assessing the impact of YFYS through interviews with CIOs of funds with performance "buffer"*. 26 July 2022. [online] Sydney: Conexus Institute. Available at: https://tinyurl.com/8se98sfc [Accessed 28 April 2023].

[3] Refer page 10, APRA 2021. *MySuper Heatmap*. Methodology paper, December 2021. [online] Canberra: Australian Prudential Regulation Authority. Available at: https://tinyurl.com/e45p78bz [Accessed 28 April 2023].

- Products using environmental, social and governance (ESG), ethical or religious standards to exclude certain assets, such as tobacco, gambling or alcohol, from portfolios may be more appropriately benchmarked to indices with corresponding exclusions.

We note the Government's announcement in April that they are committed to consideration of further changes to the test to improve fund performance. We do not believe at this point that this issue can be addressed for this financial year. However, we recommend that this be made a priority for as soon as practicable.

Trustee notification to beneficiaries

The compulsory letter required to be sent to members in the event of underperformance, as specified in the proposed Schedule 2A of the SIS Regulations, needs to be revised.

Under the new text proposed to be used under Schedule 2A, superannuation funds would be required to state that, 'Your superannuation product … has failed its annual performance test.' As noted earlier, it is possible to have failed the performance test but for the product to not have performed objectively poorly.

Funds would also be required to state that, 'you should think about moving your money to a different super product' or 'you should consider moving your money into a different super product.'

Many members may have money in both their fund's MySuper option as well as in one or more of their fund's choice products. Although these statements are not intended to mean that they should move all their retirement money to a new superannuation fund, it may easily be construed this way by members.

In the letter, members are referred to the comparison tool. Again, it is possible for a product to have performed poorly in the performance test yet rank well in the comparison tool. There is also no mention of insurance and the risks of losing cover if the member switches products, especially for dangerous occupations.

Arguably, the compulsory letter seeks to provide personal financial advice when funds cannot have sufficient member information to be making such statements to members. In addition, they may not have an Australian Financial Services License with suitable authorisations to be making such statements. We consider that any relief provided to trustees for issuing these letters obscures the fact that, although not in law, members can quite reasonably infer that they have received personal financial advice. The impact on members reading such notices must be considered, both in anticipation of actions which they may take and tools presented to assist them with choices.

Meaning of representative administration fees and expenses (RAFE)

The Exposure Draft Regulations clarify how RAFE is determined for Part 6A products, including lifecycle Part 6A products and trustee-directed products. The largest RAFE for a lifecycle product is used for both actual and benchmark RAFE, and the RAFE for trustee-directed products is determined by the standard fees and costs arrangement within each investment

pathway, which is then asset-weighted across pathways. The proposed amendments also define "investment pathway" and "investment pathway weight" and provide rules for asset-weighting RAFE across pathways for a financial year. The purpose of the amendments is to ensure the Principal Regulations remain relevant and provide certainty to trustees.

The proposed amendments appear to have addressed concerns regarding the gaming of the system by funds, but the inclusion of non-MySuper trustee-directed products raises new questions. In particular, the pending performance testing of superannuation products designed for larger balances with reduced fees will be assessed against the $50,000 member, who is not the target market for such investments. This raises additional questions about how the performance of these products will be accurately assessed, given that these funds are likely to have a considerably different demographic from the representative member used for RAFE calculations. This issue highlights the need for ongoing review and refinement of the regulatory framework to ensure that it remains effective and relevant.

Other Considerations

Performance test benchmarking

We have already noted the (in)appropriateness of prescribed benchmarks in examining portfolios which necessarily depart from indices due to investment strategies. This may be due to interests in assets outside of those indices, in which case, alternative indices may be more appropriate. In some cases, some investments will never fit a benchmark. A good example of this is early-stage private equity investments.

There is evidence that the current and proposed benchmarks are a blunt tool. More appropriate benchmarking could provide better examination of the performance of a superannuation product.

There are additional complications which arise from more sophisticated investment options such as those involving ‘glidepaths’, where the asset allocation of the investment option is progressively tilted away from exposure to longer term assets as members age.

Presently, assessment of these products is based upon a methodology which suggests that a meaningful return can be calculated by weighting each stage of a glidepath by asset totals, meaning that it does not matter at which age one joins the product, since the product is going to be considered the same way in all instances.

For example, for two different investors aged 25 and 55, who may be considering an investment in such a product, the performance test will provide precisely the same results although the actual investment experience of such investors is necessarily different by design. This means that there is likely to be a high probability of type I and type II errors with respect to the product’s underperformance: A product which performs for a specific age cohort may be restricted, while at the same time, another similar product may underperform for an age cohort to whom it is open.

This is in addition to the problem that the investment experience imagined by the operation of the performance test does not exist, since a member would need to experience all phases of a

glidepath product over the existing eight-year performance test period, with their investment allocated by the exact same proportions to fund assets as the fund itself.

CPA Australia and CA ANZ believe that a better method would see tailored twelve-year periods selected across different age cohorts, with prohibitions applying to new members at ages where the products fail testing. We do not believe that this method would be onerous to implement.

Additionally, we note that performance relative to the target return – a measure disclosed to members via fund websites and product dashboards and widely regarded as a fund's published investment benchmark – is not investigated.

The visibility to members of the overall investment objective and strategy of a superannuation product, does not extend to specific performance at an asset class level. The introduction of MySuper in 2013 was accompanied by 'product dashboards', a disclosure item designed to provide members in MySuper products with 'key information about the product in relation to five separate measures detailed in s1017BA of the *Corporations Act 2001*[4]. One of the required items of information is a 'return target': An estimate of investment performance by which the trustee is estimating that its product will perform over the next ten years, after fees and taxes. The return target must generally be shown as the increase in the Consumer Price Index (CPI) plus a percentage.

This can be different to stated investment objectives derived from a fund's internal investment strategy methodology. *Reporting Standard SRS 700.0 Product Dashboard* (SRS 700.0) requires funds to calculate a return target with respect to a representative member. The differences can be noticeable: One fund's MySuper product dashboard presently shows a return target of CPI plus 3.81%, while an investment objective listed elsewhere on its website is CPI plus 4%, both after fees and taxes.

A MySuper product is, for funds which offer them, designed to be a failsafe to cover the event that a member has not chosen their own investment option. The use of a return target recognises that trustees have designed their MySuper product with a risk and return profile which is in the best financial interests of disengaged members. However, it is possible that under the current construction of the performance test, a product with a return target of CPI plus 2% could pass the performance test and another product with a return target of CPI plus 4% could fail the test, even if the product with the higher return target has consistently outperformed the other product.

We consider that the return target, accompanied by the product's standard risk measure, is the simplest and most appropriate representation of the promise which a fund makes to its members regarding the performance of the fund. The fact that this is not subject to the

[4] ASIC, 2014. *Information Sheet 170: MySuper product dashboard requirements for superannuation trustees (INFO 170).* [online] Asic.gov.au. Available at: https://tinyurl.com/5n8rwrt8 [Accessed 28 April 2023].

performance test is perhaps the most unusual feature of the performance test as it is currently designed.

APRA decisions are not reviewable

We note that determinations made by APRA are not 'reviewable decisions'. Paragraph 2.25 of the Explanatory Memorandum to the YFYS Bill states that:

> *This is because the test results are based on product performance compared to relevant benchmarks over the assessment period. The methodology to calculate a product's performance and benchmark will be clearly specified in regulations.*

It is true that the calculation methodology is specified in regulations. However, this leaves no opportunity for recourse by trustees in the event that APRA is acting on incorrect information or has processed information inaccurately. Once an incorrect determination is issued by APRA, it will be allowed to stand permanently, and trustees have no right of redress.

The issuing of a determination where a fund has failed the performance test could potentially affect all members of a fund adversely, not just the members of the affected product(s). A failure notice – required to be provided by the trustee within 28 days – could expose members of a fund to liquidity risk, a solvency event or other problems such as increasing per member management costs.

A determination in relation to a Part 6A product must be reviewable in the event that APRA has used incorrect information in coming to a decision. Such a review must allow determinations issued in error to be revoked in full.

Problems with use of the beneficiary definition in performance test failure restrictions

Two consecutive performance test failures incurs a prohibition, where a trustee must not accept any new beneficiaries into the product. 'Beneficiaries' is a widely defined term and under the SIS Act includes a member's spouse or dependent children, in addition to members of the fund themselves. We note that the YFYS Act specifically exempts family law splits from this rule. However, the problem of changes to members' dependants remains – for example, due to having another child or commencing a new spousal arrangement.

Pension products should be included

Pension products are not part of the YFYS performance test and hence do not appear in the comparison tool tables because the current focus of these measures are accumulation products.

We note that the retirement phase is a growing part of the $3 trillion in investments currently held within superannuation funds. Similarly, members of account-based income streams are heavily impacted by investment performance, with the greatest impact of sequencing risk likely to occur around retirement.

The impact of sequencing risk is likely to be accentuated by investment into poorly performing superannuation products, which affects longevity risk, as well as quality of life in retirement as retirees compensate for poor investment performance in early retirement by drawing less from income streams.

We also note that certain designs of non-account-based income stream products may be heavily subject to forms of investment risk. These can include variable annuities and collective defined contribution products. Although these products are designed mainly to address longevity risk, income volatility risk or income yield risk, ultimately, it is either current or future investors who bear these costs. Although these are not able to be captured within the performance testing regime as readily as account-based income stream products, we do not believe that performance testing of these products is any less important.

The extension of the performance regime into retirement income products would ensure that Australians who are retiring are better protected from poor performing investment options in retirement, particularly at the point of retirement where amounts being invested are larger and potential costs of underperformance are greatest. It would also ensure that investment switches into restricted products are unavailable. Finally, it would ensure that the perverse outcome of a product being prohibited in the accumulation phase but open to members where it is mirrored in the retirement phase, is not able to occur.

We recommend that the definition of Part 6A products include products in the drawdown phase, in addition to the accumulation phase. However, this should only be implemented with great care and after broad consultation.

Defined benefits products should be included

The YFYS performance test does not capture defined benefit products. This is understandable since most Australians invest in superannuation through defined contribution superannuation products.

Nevertheless, defined benefit superannuation arrangements should be subject to some form of performance testing, since investment underperformance of fully or partially funded defined benefit arrangements is a cost to members.

In particular, we are aware of non-underwritten, fully funded, defined benefit arrangements where the multiplying factor can potentially be varied depending on the investment performance of the fund, making it conceptually similar to a crediting rate. It is not clear why the value being obtained by trustees from the implementation of their investment strategy is not being assessed in the same way that a defined contribution product would be assessed.

We also note that in a large number of workplaces, defined benefit products are offered alongside choice of fund. It is difficult to understand why employees in such workplaces would be forced to choose between products which have been tested, and a defined benefit product which has not.

Finally, we note that many defined benefit funds often have a range of investment options for compulsory and voluntary member contributions where the member bears the investment risk.

We believe that consideration must be given to the rating of the performance of defined benefit products, particularly where these products are not underwritten.

Assumed taxation

We believe the assumed tax rates are not realistic. For example, we note that item 1 in the table at 9AB.17(7) of the *Superannuation Industry (Supervision) Regulations 1994* (the "SIS Regulations") suggests that the assumed rate of tax for the benchmark index to be used for Australian equities is zero.

This assumption may be correct if the benchmark to be used is providing a comparison on a pre-tax basis. However, the intention of the performance test is to provide a representative benchmark after fees and taxes. This is recognised where some of the other asset classes assume a 15 per cent, or very close to 15 per cent tax rate. However, the presence of imputation credits does not necessarily mean that zero per cent tax can be assumed in all instances. That is, it is not correct to assume that all returns from dividends are fully (or even partially) franked. Also, returns posted by superannuation funds on their Australian equities' portfolio will also include both realised and unrealised capital gains.

Further, franking credits do not alter an investors actual tax rate. They merely change the timing of when that tax is paid.

We would be pleased to liaise with Treasury on this matter to ensure that there is a complete understanding of the issues.

Stapling

CPA Australia and CA ANZ have generally supported the concept of stapling – that is, a fund which an employee's superannuation contributions are paid into by their employer if they have such a stapled fund and have not chosen a different fund.

Employers must follow a minimum series of steps in order to satisfy the aims of the choice of fund and stapling measure, which is the reduction in the proliferation of multiple accounts. We note that, ultimately, where a contribution is made which is not in accordance with the choice of fund rules, the employer may be subject to the Superannuation Guarantee Charge, which can include a director penalty, an administration penalty and/or the General Interest Charge (GIC).

The Commissioner of Taxation has the discretion to reduce the superannuation guarantee shortfall to zero in the event that contributions are late. However, this discretion does not cover a scenario where the payment was received late or incorrectly due to an ATO administrative error.

We recommend that where there is an ATO administrative error, where the ATO either:

- Fails to provide information in relation to an employee's stapled fund
- Provides late information in relation to a stapled fund

- Provides incorrect information in relation to a stapled fund, or
- Provides details of a stapled fund which is incapable of accepting contributions

which results in the employer paying a contribution to an incorrect fund under the choice of fund rules, it is expressly legislated that this does not result in a penalty to the employer.

Employers face a superannuation guarantee shortfall charge penalty if a valid contribution is not made to a stapled fund where one exists. For details of stapled funds, employers are to contact the ATO and seek details for each new employee. We note that where a payment is made in error, the shortfall charge will apply. However, there is discretion where a stapled fund is unable to accept contributions. In addition, the Commissioner of Taxation is allowed to correct errors in notifications to employers about stapled funds. However, an employer is not expressly permitted to rely on representations made by the ATO where these were in error, or to use a default fund in the instance that the ATO does not respond to a request for details about stapled funds.

Finally, there are no requirements for the ATO to verify that a stapled fund is able to accept contributions. This can result in delays where employers, upon becoming aware of stapled funds which cannot accept contributions from them, must contact the ATO for confirmation.

We note that under the Superannuation Guarantee and tax requirements, the employer must still obtain evidence to prove that a stapled fund to which it contributes, or aims to contribute, is both complying and can accept employer contributions. Employers can be penalised if they do not comply with this requirement. However, there is nothing that prevents such penalties from applying if an employer is forced to breach these requirements.

The following requirements are essential:

- Employers must be deemed to have complied with the choice of fund requirements if they rely on representations by the ATO, even if made in error, in respect to notification of stapled fund details
- Employers must be deemed to have complied with the choice of fund requirements if they contribute to a default fund due to the employee having not chosen a fund and the ATO having not responded to a request for details of the employee’s stapled fund, and
- Employers must be allowed to accept that stapled fund details provided by the ATO represent a complying fund which can accept employer contributions.

The ATO should be required to ensure that a stapled fund is both complying and permitted to accept contributions before an employer is advised of its status. The requirement for employers to verify this separately should be removed with respect to stapled funds.

Restricted products

Employers are required to consult Super Fund Lookup in the instance that a new employee selects their own fund under the choice of fund requirements. We note that non-complying

funds, which in the majority of cases will be SMSFs, will not show up on Super Fund Lookup. However, it is also possible that a non-complying fund is the employee's stapled fund. In such a case the fund will be made non-complying, removed from the Super Fund Lookup, and superannuation fund monies will need to be contributed to the employer's default fund in the absence of another fund being chosen.

In the case of complying funds, CPA Australia and CA ANZ note that superannuation fund products that are subject to an APRA-imposed prohibition under the performance test can still be both stapled funds, and valid fund selections on the Super Fund Lookup. While we agree that the primary grounds for removal for a fund from the Super Fund Lookup should be a status of non-complying, the policy basis for a prohibition notice is to prevent new members moving into that product.

This issue raises two questions. Does the commencement of new employment circumstances represent a reasonable opportunity to encourage engagement by the employee with their underperforming stapled fund? If yes, is it appropriate for restricted products to continue to be listed on the Super Fund Lookup or to be allowed to be stapled funds?

While we do not make recommendations in respect of this matter, we believe that this is an important public policy question, particularly if new employment is an ideal time for an employee to move to a new, better performing, product. We consider this question to be of critical importance in the event that insurance arrangements in a stapled fund are inappropriate for an employee's new role.

Best financial interests duty ('BFID')

CPA Australia and CA ANZ remain of the view that the introduction of the BFID, which now applies to trustees in respect of their members, was a retrograde measure. This duty, which replaced the former best interests duty, is not a higher hurdle but rather a subset of the former duty. A singular statutory BFID is a lower standard than the existing duty.

We agree with comments made by Commissioner Hayne in the final report of the *Royal Commission Into Misconduct In The Banking, Superannuation And Financial Services Industry* where he wrote at page 235:

> *I consider that the existing rules, especially the best interests covenant and the sole purpose test, set the necessary standards. Those standards should be applied according to their terms and without more specific elaboration.*

An important court case concerning trustees acting in beneficiaries' best interest is *Cowan v Scargill [1985] Ch 270*. In this case it was found that if the purpose of a trust is to provide financial benefits then the beneficiaries' best interests are 'normally their best financial interests' (our emphasis).

We take this to mean that, at times, a best interest duty for a superannuation fund trustee can be wider that a best financial interest duty.

We note that the sole purpose test allows for a number of payments to be made which may conflict with the BFID. One example is the provision of death benefits to a member's dependents. Superannuation funds can provide death insurance but the cost of this insurance may not be in the best financial interests of all beneficiaries of the fund. This conflict must be resolved.

The BFID measure, as legislated, includes a specific reversal of the evidential burden of proof and is not subject to a materiality threshold, essentially requiring a few cents of postage to be justified by trustees in the event that this is queried by the relevant regulator. This is costly, is not in the best financial interests of members, and is not supported by CPA Australia and CA ANZ. Although at the time the legislation was in front of Parliament we welcomed the fact that the reverse onus does not apply to trustees of Self-Managed Superannuation Funds (SMSFs), we did not support APRA-regulated superannuation funds being made subject to this reverse onus.

It is important to note that trustees who breach other regulatory provisions could be penalised for breaching the BFID, leading to concerning outcomes. One such problem is the interaction between the proposals and the Non-Arm's Length Income and Expenditure (NALI/E) requirements for superannuation fund trustees. Indemnifying trustees (and directors of corporate trustees) for normal trust expenses is common across all types of trusts, including APRA-regulated funds. A trustee who is unable to obtain evidence that a payment to a trustee (or director), or any other related party, is in members' best financial interests may decide not to indemnify that expense. It is possible that a trustee or director who is unable to be indemnified may instead cause the fund to breach the NALI/E provisions as a result. This is an unacceptable outcome.

It remains unclear which statutory provision superannuation funds should seek to apply first when they conflict with each other. That is, the NALI/E requirements or the BFID. In all respects this is unsatisfactory.

Finally, CPA Australia and CA ANZ remains concerned about the record-keeping requirements being a strict liability offence under additions to Section 34 of the SIS Act.