Your Future, Your Super Review outcomes – draft Regulations

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

However, as discussed in our submissions to the Your Future, Your Super Review, significant changes are needed to ensure the reforms work in the best interests of members. The *Superannuation Industry (Supervision) Amendment (Your Future, Your Super – Addressing Underperformance in Superannuation) Regulations 2023* are not sufficiently resolved or comprehensive enough to address these concerns.

While we recognise that in addition to these proposed regulations, the Government has acknowledged the need to improve certain aspects of the reforms in the longer term – such as the performance test and ensuring stapling operates efficiently – ISA urges the Government to deal with these issues as soon as practicable. Continued delays will compromise the retirement outcomes of members, and making incremental tweaks to the system instead of introducing a cohesive and substantial package of reform creates unnecessary uncertainty for industry and members.

This submission focuses specifically on the *Superannuation Industry (Supervision) Amendment (Your Future, Your Super – Addressing Underperformance in Superannuation) Regulations 2023* and the Government's response to the Your Future, Your Super Review. The following recommendations therefore apply in addition to the recommendations in our previous submissions to the Review.

Summary of our submission

- ISA strongly encourages the Government to direct the ATO to change the YourSuper comparison tool so that products are sorted based on net returns by default (from highest net returns to lowest) before the 2023 performance test results are published. Where a product has a range of returns, for example lifecycle products, the product should be ranked based on asset-weighted returns across the life-stages.
- Consistent with our previous submission, ISA supports prospectively increasing the testing period from eight to ten years to encourage longer-term investment decisions.

- ISA believes the addition of extra benchmark indices and voluntary reporting further diminishes the transparency and simplicity of the performance testing regime, increasing opportunities for gaming the test. A better approach is to replace 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.

  If the Government chooses to proceed with the additional indices, they should only be utilised for prospective SAA reporting and performance testing from 30 June 2023.

- ISA does not support adoption of a separate performance measure or BRAFE for trustee-directed products. Administrative fees and costs should also be aligned to the lookback period of the performance test to reflect the member outcomes delivered and not omit all but the last 12 months of administrative fees and costs.

- ISA recommends that the Government do more than acknowledge that more substantial changes to the performance test may be required and commit to consulting on amendments next year to address the harm arising from the flaws in the performance test and the inefficient operation of stapling.

- ISA strongly encourages the Government to prioritise reforms to prevent inappropriate behaviour by software providers that undermines stapling reforms, by undertaking a broad consultation process to understand and respond to these issues.

- ISA supports the proposed changes to the letter funds that fail the performance test are required to send to members but encourages the Government to fix the comparison tool website to avoid connecting members with poor performing products and consider how the letter could better interact with merger discussions.

Improvements to the YourSuper comparison tool default sorting method

ISA strongly encourages the Government to amend the YourSuper comparison tool default sorting method before the 2023 results are published.

The comparison tool sorts products from lowest to highest annual fees by default, instead of by net returns. Where a product has a range of fees, for example for lifecycle products, the lowest fee is used for ranking purposes. In our view, this approach is deeply flawed and is directing consumers to poor performing products and therefore poorer retirement outcomes. While fees are an important consideration, it is net returns that matter to member outcomes.

As shown in our submission to the Review, and extracted again below, the correlation between fees and net returns is weak (see figure 1A) while there is virtually no correlation between the default rankings of the YourSuper comparison tool and long-term net return rankings (see figure 1B).

Since our submission to the Review the comparison tool rankings have changed.

The default sorting method previously resulted 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 was 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.

The comparison tool also allows new and untested products to be promoted on the platform, undermining the policy intent of the tool to connect members with quality tested super products.

As at 1 May 2023, the QSuper Lifetime product was ranked first. Vanguard MySuper was ranked second, despite not having passed a performance test – the tool labels the product as 'performing' while no net return value is available for the product. New products do not face a performance test until five years of performance data are available.

The way in which the comparison tool displays and promotes new and untested products further highlights the absurd inadequacy of the current design. If the policy intent is to connect members with good performance-tested products:

- the tool should default sort by net returns,
- untested products should be more appropriately displayed, and
- the tool should be properly consumer tested.

It would be more useful for consumers if products are sorted based on net returns by default (from highest net returns to lowest). Where a product has a range of returns, for example lifecycle products, the product should be ranked based on asset-weighted returns across the life-stages.[1] 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.

If the policy objective of the comparison tool is to guide consumers to make positive informed decisions about their retirement savings, changes must be made to improve the comparison tool before the next performance test results are published and consequences for failure are triggered.

Figure 1A: Total fees vs net returns, June 2022

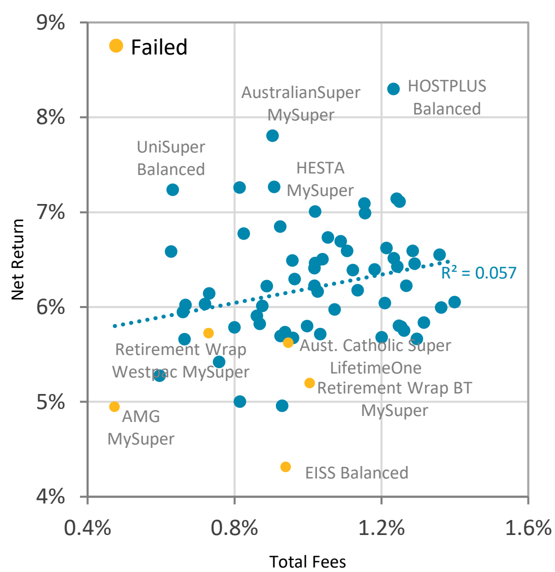

Figure 1B: Default sorting vs net return rank

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: ISA strongly encourages the Government to direct the ATO to change the YourSuper comparison tool so that products are sorted based on net returns by default (from highest net returns to lowest) before the 2023 results are published. Where a product has a range of returns, for example lifecycle products, the product should be ranked based on asset-weighted returns across the life-stages.

[1] The current tool produces very perverse outcomes where, for example, ranking products by net return leads to Australian Retirement Trust's QSuper Lifetime product (net return of 2.54%-7.11%) being ranked above UniSuper's Balanced product (net return of 6.93%), despite 7 of the 8 lifestages having a lower net return and the worst performing lifestage, "Sustain 2 Group", having a net return of 4.39% per annum below UniSuper's option.

Increased testing period

ISA supports prospectively increasing the testing period from eight to ten years to encourage longer-term investment decisions.

As set out in our submission to the Review, in general, products should be assessed over the longest time period possible to:

- account for risk and market cycles and allow for a better assessment of the resilience of investment portfolios along with trustees' responses,
- reflect that superannuation is a long-term investment and illiquid asset classes have inherently long horizons, and
- align with existing ten-year Government guidance and regulated disclosures for consumers on assessing returns.[2]

Recommendation: Consistent with our previous submission, ISA supports prospectively increasing the testing period from eight to ten years to encourage long term investment decisions.

Calibrating benchmarks

ISA was among those who made a strong case in submissions to the Review to move to a simplified benchmark and more robust assessment for risk.[3] Increasing the number of indices seems to move in the opposite direction.

It is unclear how the additional benchmark indices strengthen the test in their current form. While changes to the existing infrastructure benchmark will potentially better facilitate investment in renewable energy infrastructure, the addition of further indices increase the test's complexity and increase the potential for retrospective changes to strategic asset allocations (SAAs) to enable marginal products to pass. For example, for a MySuper Product with 30-35 per cent of assets allocated to International Equities, revisiting the SAA from a 90-10 split between Developed and Emerging markets to a 75-25 split improves test outcomes by around 30-35 basis points – more than enough for a fund otherwise failing the test to pass.

If the Government does proceed, important safeguards are needed to prevent gaming of the test. For example, funds should only be able to report prospectively on new SAA categories associated with new benchmark indices and not retrospectively recast their SAAs against asset allocations that cannot be verified. Actual asset allocations also need to be published so there is appropriate scrutiny on trustees that might be manipulating their SAA benchmark to pass the test.

Such resubmissions were a feature of the inaugural test with significant movement in SAA's away from higher to lower return asset classes in around one quarter of MySuper products. APRA should be attuned to material resubmissions of SAA by funds.

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[2] ISA, *Your Future, Your Super Review – Performance test methodology supplementary submission* (15 November 2022), p. 12.
[3] See also IFM Investors, *Review of Your Future, Your Super Measures* (14 October 2022).

The addition of further benchmark indices also results in unacceptable regulatory costs that are imposed on funds. Subscription to the proposed full range of indices run into hundreds of thousands of dollars per fund which replicated across the industry result in tens of millions in costs that are ultimately borne by members. In our view, the index data should be made available to funds on a cost-effective basis and Treasury/APRA should facilitate this process.

Recommendations: ISA believes the addition of extra benchmark indices and voluntary reporting further diminishes the transparency and simplicity of the performance testing regime increasing opportunities for gaming the test. A better approach is to replace 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.

If the Government chooses to proceed with the additional indices they should only be utilised for prospective SAA reporting and performance testing from June 30 2023.

Performance measure and BRAFE for trustee-directed products

ISA does not support adoption of a separate performance measure incorporating different calculation of the benchmark representative administration fees and expenses (BRAFE) for trustee-directed products.

The draft regulations introduce a separate BRAFE for trustee-directed products. ISA analysis based on the most recent Choice Heatmaps (data to October 2022) shows that the median annual administration fee charged on a $50,000 super balance across Choice products was 38 per cent higher than the MySuper equivalent (40 vs 29 bps – see Table 1). In dollar terms, this amounts to $55 per annum in additional fees.

Notably, the difference in member-weighted medians between MySuper and Choice products is much smaller, at 3 basis points or $15, suggesting that the typical administration fee a member is charged across the two sectors is not as different as the product medians would suggest.

No sound basis has been provided for a separate administration fee benchmark for different product types.

Table 1: Median (product-weighted, member-weighted, asset-weighted) annual administration fees disclosed on a $50,000 account balance across MySuper and Choice products, as at 1 October 2022.

Measure	Product Weighted		Member Weighted		Asset Weighted	
	MySuper	Choice	MySuper	Choice	MySuper	Choice
Dollars	$145	$200	$130	$145	$125	$125
Percentage	0.29%	0.40%	0.26%	0.29%	0.25%	0.25%

Source: ISA Analysis, APRA Choice Heatmap, April 2023, APRA MySuper Heatmap, February 2023, APRA Quarterly Superannuation Industry Publication, June 2022. Note: Choice category includes the set of multi-sector accumulation products available through generic investment menus reported in the 2023 APRA Choice Heatmap.

Introducing a higher benchmark RAFE for trustee-directed products is therefore likely to inappropriately entrench high fees with significant profit margins. ISA analysis of APRA data shows that funds offering fewer investment options (MySuper products) have consistently performed better than funds that offer hundreds of investment options (Choice products). This analysis suggests that the proliferation of investment options is motivated by a for-profit business model in which:

- For-profit Choice funds have an interest in capturing margins at multiple points in the investment value chain including extracting fees when members change options,
- Maintaining sufficient liquidity to facilitate large volumes of investment switching means for-profit Choice funds are more likely to invest in highly-liquid asset classes for short time periods, forgoing investments in better performing but less liquid long-term assets such as infrastructure,
- Offering a multitude of investment options is used as a deliberate strategy to shift costs and risks to consumers.[4]

The latest Choice heatmaps add to the weight of evidence in support of greater measures to protect members from high fees and poor performance. They showed:

- Almost half of products with an 8-year performance history underperformed the benchmarks, with almost half of these by more than 0.5 per cent,
- Less than a third of Choice sector assets were subject to the Choice heatmap assessment, highlighting the pressing need to expose the entire sector to performance assessment, including single asset class options (some single asset class options were heatmap-assessed, with many performing badly) and retirement income products,
- Choice products closed to new members, virtually all contained within the retail sector, continue to gouge members with high fees and poor performance – two-thirds had poor or significantly poor performance relative to the benchmark and average fees were higher.

The heatmaps include some single asset class options which are not in scope of the performance test for TDPs so the upcoming extension will cover significantly less than half of Choice assets. Significant fee and performance issues continue to be exposed in the Choice sector time and time again, yet it continues gouging members while avoiding even the most basic scrutiny members should expect of a compulsory retirement income system that requires them to set aside over one in ten dollars earned.

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.[5] 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.[6]

[4] ISA, *Options to Lose: How "sales" became "choice" and the impact on superannuation returns* (June 2017).
[5] Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness* (December 2018), box 3.4 p. 186 and figure 3.2 p. 187.
[6] Ibid – Cameo 3, p. 14.

Consumer protections should be commensurate with the potential loss members incur when they are left in a poor performing, high fee fund, which is significant. Trustees can make commercial decisions to complicate or simplify their product offerings. The benchmark RAFE should not be used to support more complex and higher fee-paying products. In our view, the benchmark RAFE should be the same across all products (in a similar way that asset class specific investment fees/costs are standardised) so there is competitive pressure across the industry to offer products in the best interests of members.

Recommendation: ISA does not support adoption of a separate performance measure or BRAFE for trustee-directed products. Administrative fees and costs should also be aligned to the lookback period of the performance test to reflect the member outcomes delivered and not omit all but the last 12 months of administrative fees and costs.

More changes are needed

ISA notes that in addition to these proposed regulations, the Government has acknowledged the need to improve certain aspects of the reforms in the longer term – such as the performance test and ensuring stapling operates efficiently. ISA urges the Government to deal with these issues as soon as practicable. Continued delays will compromise the retirement outcomes of members, and making incremental tweaks to the system instead of introducing a cohesive and substantial package of reform creates unnecessary uncertainty for industry and members.

Recommendation: ISA recommends that the Government do more than acknowledge that more substantial changes to the performance test may be required and commit to consulting on amendments next year to address the harm arising from the flaws in the performance test and the inefficient operation of stapling.

Software providers and stapling

The stapling reforms were introduced for the important purpose of reducing the number of unintended multiple accounts. This was and remains a major source of inefficiency in the superannuation system as it reduces Australians' retirement savings through unnecessary multiple fees.

The stapling reforms, which aim to ensure that a member remains with a single fund throughout their working life unless an active decision is made to join a new fund, will only be effective if:

- the public (both employers and employee members) are aware of the fundamental importance of the stapling laws, and
- employees are, through their employer, given accurate, balanced and factual information as to the superannuation fund selection options available to them. This is critical to ensure that the fund selection made by employees, which will affect their savings over their working life and into retirement, is based on meritorious, relevant and informed considerations.

In short, the legislative system incorporating the stapling reforms should work to ensure that employees choose a strong performing fund, which best suits their individual needs and circumstances.

ISA notes the Government's commitment to address the significant issues identified in the Review in relation to stapling. The Government's response specifically identifies the inappropriate behavior by software providers which is circumventing and therefore undermining the intent and operation of the stapling laws to the detriment of members' retirement outcomes.

An example of this inappropriate conduct that has been widely reported in the media is the operation of the Flare HR platform which is owned by MYOB. The platform allows new employees using the platform to choose a fund as part of an employee's onboarding journey. One of the funds includes the underperforming and high fee Slate Super fund. Like the platform itself, the Slate Super fund is owned by MYOB.[7]

ISA understands there is a broad spectrum of conduct by software providers – some of which is inappropriate and undermines the objective of stapling. In our view, it is an insufficient and naïve response for Government to expect that the inappropriate behavior will cease voluntarily. We therefore recommend that the Government undertake a broad consultation process to better understand how these onboarding platforms operate and identify instances of inappropriate conduct. The Government should then prioritise any legislative reforms that are needed to clarify the intended policy outcome and prevent this conduct from occurring. At the same time, ASIC should also take strong and public regulatory action where appropriate.

Recommendation: ISA strongly encourages the Government to prioritise reforms to stop inappropriate behaviour by software providers that undermines stapling reforms by undertaking a broad consultation process to understand and respond to these issues.

Communicating to members of products that fail the performance test

The proposed changes are more direct, make the letter clearer and focus on action members can take to switch out of underperforming funds. However, without fixing the YourSuper comparison tool (discussed above) the letter is not connecting members with good quality funds.

The Government should also consider how the letter interacts with merger discussions that may be underway, as discussed in our submission to the Review.

Recommendation: ISA supports the proposed changes to the letter funds that fail the performance test are required to send to members but encourages the Government to fix the comparison tool website to avoid connecting members with poor performing products and consider how the letter could better interact with merger discussions.

[7] The Australian Financial Review article, "*MYOB allegedly manipulating users into joining its sub-par super fund*" (12 March 2023).