

16 August 2022

Director, Member Outcomes and Governance Branch
Retirement, Advice and Investment Division
Treasury
Langton Cres
PARKES ACT 2600

Via email: superannuation@treasury.gov.au

Dear Sir/Madam

Superannuation Performance Test Treatment of Faith-based Products

CPA Australia and Chartered Accountants 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.

CPA Australia and Chartered Accountants Australia and New Zealand (Chartered Accountants ANZ) welcome the opportunity to provide comments on the Exposure Draft Bill *Treasury Laws Amendment (Measures for a later sitting) Bill 2022: Faith-based products* consultation, presently underway at Treasury.

The Exposure Draft Bill (the ED) proposes that trustees would be able to apply to the Australian Prudential Regulation Authority (APRA) to have superannuation products labelled as 'faith-based products', which would allow such products to be eligible for a supplementary performance test in the event that the product fails the 'normal' annual performance test. Eligible faith-based products which pass the supplementary test would continue to be considered to have passed the performance test.

The supplementary test to be administered by APRA would be compiled with the use of indices provided by the trustee as part of their application. Such indices are expected to be customised to reflect the faith-based investment strategy implemented by trustees for that product.

CA ANZ and CPA Australia recognise that the Government intends to proceed with this policy as it was something to which the Australian Labor Party committed during the recent Federal election campaign. However, we believe that the issue of ill-fitting indices being used to benchmark superannuation fund products as part of the performance test is likely to form a key issue of the upcoming review of the *Your Future, Your Super* reforms (YFYS). As such, we recommend that this measure not proceed until after the review has been undertaken.

We believe that the problem of inappropriate benchmarking is not limited to faith-based products. As such, the ability to apply for access to the supplementary performance test must also be made available for non-faith-based superannuation fund products for which APRA's chosen indices are inappropriate, such as products unique to a particular industry or profession, or products designed for investors with ethical or sustainable preferences.

More information regarding our recommendations may be found in our submission (attached).

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 Leader at Chartered Accountants ANZ at Tony.Negline@charteredaccountantsanz.com.

Yours sincerely

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Response to consultation

Executive summary

CPA Australia and CA ANZ note that this consultation fulfils an election commitment made by the Government prior to the federal election. It would allow APRA to consider the faith-based investment strategy of a superannuation product when applying the annual performance test.

The ED proposes that trustees would be able to apply to APRA to have superannuation products labelled as 'faith-based products'. If approved, such products would be eligible for a supplementary performance test in the event that the product fails the 'normal' annual performance test. Eligible faith-based products which pass the supplementary test would be deemed to have passed the performance test.

The supplementary test, to be administered by APRA, would be compiled with the use of indices provided by the trustee as part of their application or such other indices that APRA considers appropriate. Such indices are expected to be customised to reflect the faith-based investment strategy adopted by trustees for that product.

CA ANZ and CPA Australia believe that this consultation is premature. The pending review of the YFYS reforms – which includes the performance test – is likely to consider the appropriateness of APRA's approach to benchmarking involving a series of specified indices which are used in the performance test.

It is our view that, failing the deferral of this consultation until after the review of the YFYS reforms, adjustment to the performance test to take account of both faith-based and non-faith-based investment strategies would enable superannuation fund products to be more appropriately benchmarked to indices which reflect their investment objectives and strategy.

For these reasons, we recommend that this faith-based measure be deferred until after the conclusion of the YFYS review. In the event that the measure is not deferred, we recommend that the ability to apply for assessment under the supplementary test be extended to non-faith-based products, where the trustee operates an investment strategy for which APRA's preferred indices are inappropriate. This includes superannuation products that may be unique to a particular industry or profession, or products designed for preferences of investors, such as ethical or sustainable funds.

We note that in any event, the performance test fails to measure products' performance to their stated return targets published by trustees as part of MySuper product dashboards. The proposed measures would fail to address this inconsistency for both faith-based and non-faith-based products.

The pending YFYS review

On 7 July 2022, the Assistant Treasurer and Minister for Financial Services, the Hon. Stephen Jones MP, announced a review into the YFYS reforms, which includes the performance test, legislated in 2021. The introduction of the performance test was generally supported by CPA Australia and CA ANZ. However, we also noted at the time that we had significant concerns about its practical operation. The test presently applies to MySuper products, and while it was introduced for an initial year in relation to trustee-directed choice products, the test itself has been paused for this year for these products pending the findings of the review.

The performance test operates on two criteria:

- Investment performance is assessed relative to a benchmark portfolio obtained through the product's strategic asset allocation, and
- Administration fees are assessed relative to the median fee charged across the category.

Products which underperform by more than 0.5% will be considered to have failed the performance test.

In the Minister's media release, the operation of the performance test was identified as having the potential to create 'perverse or unintended outcomes' for members. One of the issues identified in relation to the operation of the performance test is the use of selected benchmarks. In many cases, these benchmarks 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 (APRA 2021:23) specifies the S&P/ASX 300 index for assets held within a product which invests in Australian listed equities. This would be regardless of whether the product's investment strategy would consider this to be a relevant benchmark, or if the product's investment strategy invests in alternate assets. For example, if the investment strategy of a product required exposure to Australian listed equities via small cap companies, the S&P/Small Ordinaries index may have been more appropriate than the S&P/ASX 300 index. This is despite the stated aim of the Strategic Asset Allocation (SAA) benchmark portfolio (APRA 2021:10) to assess the 'licensees' implementation of its 'investment strategy'.

Another example is a customised benchmark for a product applying an ESG screen to exclude certain industries such as tobacco or gambling. In the same way, a Shariah-compliant investment fund may use a custom index to exclude alcohol or pork production. The ED proposes a methodology in which an investment strategy is able to be benchmarked against indices that are more appropriate than those chosen by APRA. This approach could easily be suitable for faith-based and non-faith-based investment strategies.

We consider that the 'perverse or unintended outcomes' highlighted by the Minister are broad evidence of benchmarks being used as a blunt tool, whereas more appropriate benchmarking could provide better examination of the performance of a superannuation product. We also believe that the shortcomings are symptomatic of broader problems with the benchmarking currently used in the performance test, rather than merely being problems faced by faith-based products.

For these reasons, we recommend a different approach to addressing this problem. Namely:

1. It is our belief that a more appropriate place to consider the problems of inaccurate benchmarks is the pending YFYS reform review.
2. Consistent with the above point, we recommend that this consultation is paused pending the review.
3. In the event that the legislation proceeds, we recommend that the following take place:
 - a. The legislation is included in the scope of the YFYS review, and
 - b. The scope of the legislative change is extended to products built around non-faith-based investment strategies for which APRA's chosen benchmarks are inappropriate.

Detail in the Exposure Draft

The process outlined in the Exposure Draft Explanatory Memorandum (the EM) would see trustees applying to APRA for a determination that a product is a 'faith-based product'. The EM describes— in Paragraph 1.18 – the application process as required by the proposed new subsections 60L(2)-(3):

In order to be a valid application, an application must contain:

- *A declaration from the trustee(s) that the product's investment strategy accords with faith-based principles;*
- *A declaration from the trustee/trustees that they have:*
 - *Disclosed their faith-based investment strategy to members of the product in their regulated disclosures; and*
 - *Disclosed their faith-based strategy in marketing materials;*
- *One or more indices which APRA could use to assess the product's performance; and*
- *Any other information prescribed by the regulations or a legislative instrument.*

Applications are then subject to approval by APRA. They must be received by APRA by 31 January of a financial year in order to be eligible to be approved for that particular financial year.

We note that although these are to be supported by regulations that can be made under subsection 60L(3), there is no objective definition of 'faith-based product', apart from a circular reference to subsection 60L(4) which specifies that this is essentially whatever APRA determines the product to be.

We do not believe that this is helpful to either APRA or trustees in making or considering applications for consideration as a faith-based product. We are particularly concerned about several pieces of information which we believe are missing from the ED:

1. A definition of 'faith-based product' which is not circular
2. Details regarding how APRA should address any overly narrow investment strategies and which may encourage investment decisions which conflict with the sole purpose test
3. Guidelines for APRA in approving proposed indices to be used for benchmarking investment performance, or determining (as proposed in subsection 60P(3)) alternative indices to be used in the event that APRA determines that the proposed index is not appropriate.

There appears to be no avenues of redress available in the event that APRA makes a mistake in assessing the application. We note the EM's statement (at paragraph 1.16) that:

APRA's decision whether or not to determine a product is a faith-based product will not be a 'reviewable decision' within the meaning of the SIS Act. This is because the requirements for the faith-based status determination are clearly specified in the SIS Act (and will be further specified in the regulations) and the determination is based on whether certain information, already available to trustees, is provided to APRA or not. APRA will engage with the applicant trustee(s) on the information provided during the period between the application being submitted and 31 March.

Given that the requirements are not clearly stated in the ED, and that the draft regulations have not yet been made available for consultation, we disagree with the basis for this assessment and recommend that APRA be made accountable for such decisions.

Timing

We note that the earliest that legislation could be introduced to Parliament, passed and granted Royal Assent would be November 2022. This will make the timing of applications difficult, as they would then need to be received by APRA prior to the end of January 2023. We are concerned that this leaves little time for trustees for the 2023 financial year. While we understand that APRA may require 'sufficient time to consider faith-based status applications, engage with applicants, and subject the relevant products to both the original performance test and the supplementary performance test by the deadline for the test' (from the EM paragraph 1.24), these dates may need to be adjusted for this financial year.

Additionally, we note that there is no accommodation for funds which do not operate on a traditional financial year. We recommend that subsections 60L(5)-(6) be adjusted to reflect application and approval due dates of five and three months prior to the end of the financial year, respectively, be used for such funds.

References

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ASIC (Australian Securities and Investments Commission), 2014. *Information Sheet 104: MySuper product dashboard requirements for superannuation trustees*. [online] Asic.gov.au. Available at: <https://tinyurl.com/5n8rwt8> [Accessed 10 August 2022].

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