Friday, 19 April 2024

Superannuation Efficiency and Perfomance Unit
Retirement, Advice and Investment Division
Treasury
Langton Cres
Parkes ACT 2600

Submitted via email: *yfys@treasury.gov.au*

Dear Sir/Madam

Annual Superannuation Performance Test- Design Options Consultation Paper ('Consultation Paper')

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

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 Consultation Paper seeks to allow interested parties to provide feedback "on options to improve the sophistication of the test in the long-term". It provides four options, including:

- Retaining the status quo with some enhancements
- An alternative single metric framework
- A multi-metric framework
- Ideas for alternative frameworks.

We welcome the government's desire to improve these rules. However, we believe that even after any amendments that may be made to the performance test as a result of this consultation 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, Superannuation Lead 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 .

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Sincerely,

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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.

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 pointed out by other professional associations and other stakeholders, 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.

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].

[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].

[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].

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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*.

Benchmarks of covered asset classes

We note additional benchmarks were recently inserted into the YFYS assessment process. However, in many cases, the benchmarks chosen do not necessarily resemble those used by trustees, asset consultants and investment managers in the construction of a product. Additionally, 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.
- Products using environmental, social and governance (ESG), ethical or religious standards to exclude certain sectors, such as tobacco, gambling or alcohol, from portfolios may be more appropriately benchmarked to indices with corresponding exclusions.
- Passive investment styles which involve emulating stock market indices (from which APRA has selected SAA benchmarks), and therefore have little tracking error, are treated the same way as other investment styles which are not or only partially intended to adhere to index portfolios.

We are concerned that RSEs are incentivised by the performance test to adjust their investment strategies in a way which is likely to generate more favourable treatment under the performance test. We are also concerned that investment styles adopted by funds, whether these are passive, active or hybrid styles, are not adequately disclosed to members as part of

[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].

their required disclosure. Finally, we are concerned that RSE licensees may be incentivised as part of their fee structures to arbitrage the difference between the relatively low-cost of index management and the leeway of 0.5% provided under the performance test for financial gain.

We believe this allowance of 0.5% is too high for indexed investment options and recommend that this figure be reduced depending on the proportion of the portfolio which is not actively managed.

CPA Australia and CA ANZ have additional concerns regarding the unwillingness to address the use of inappropriate benchmarks where the investment strategy would introduce mismatches. We believe that in the case of listed investments, obtaining indices that more closely match the assets prescribed under that investment strategy is a trivial matter. For more bespoke strategies, this may be more difficult, however the approach used by APRA should be to reduce avoidable tracking error wherever possible. In cases like unlisted assets or other assets which may require benchmarks which are difficult or expensive to source, consideration could be given to providing an option for RSE licensees to partially fund the use of these benchmarks, or use the default benchmark provided by APRA.

Additionally, we recommend that disclosure be improved to ensure that investment strategies of choice and MySuper investment options are better disclosed to fund members. This disclosure must at a minimum explain the intended benchmarks used as part of investment strategies, any applicable return targets and the investment style.

We do not support the use of an alternative single-metric test for risk adjusted returns such as the Sharpe ratio, peer comparison returns or simple reference portfolio (SRP) frontier. It is not that we do not consider these options to have utility. The performance test and its assessment process should be relatively easy for most consumers to understand, and our concern is that these concepts do satisfy this objective.

Trustee notification to beneficiaries

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

Under the text which is required to be used under Schedule 2A, superannuation funds must state that, 'Your superannuation product … has failed its annual performance test.' As noted elsewhere in this submission, it is possible to have failed the performance test but for the product to not have performed objectively poorly.

Funds are also 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.'

It must be remembered that a fund's MySuper option is generally one of multiple available investment options which may be chosen by members of a fund. 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, and this may have been a result of personal choice or through implementation of a

considered strategy undertaken with personal financial advice. Although these statements are not intended to mean that they should move all their retirement money to a new superannuation fund, it is likely to be construed this way by some 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. We note in passing that the consultation paper still does not satisfactorily address members who retain membership of a superannuation fund purely for insurance reasons.

Arguably, the compulsory letter seeks to provide what amounts to 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 express authorisation to provide financial advice. 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.

Representative administration fees and expenses (RAFE)

Recent changes to the YFYS regulations have changed 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.

We discuss lifecycle products, also known as ‘glidepaths’, later in this submission.

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, and fee structures, 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 the design of investment strategies. This may be due to interests in assets outside of those indices (or targeted divestment from specific assets within 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 lifecycle products 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.

We are unable to provide any definitive data but we understand that some superannuation funds adjust the return target of specific investment options at random intervals and are able to do this without announcing these changes to members or the public, generally. Our reading of the legislation suggests that these changes are permitted. We encourage the government to consider removing this flexibility and requiring such changes to be communicated to members in a timely manner.

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

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[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].

To counter the perception that funds may be incentivised to set their return target too low, an upper bound may be a sensible addition to guard against fund trustees that subject their members to excessive investment risk.

Finally, the standard risk measure is generally perceived as a measure of volatility in the short to medium term. To better serve the nature of superannuation, a long term risk measure should be developed to better convey concepts such as inflation risk.

APRA decisions are not reviewable

We note that determinations made by APRA are not 'reviewable decisions'. Paragraph 2.25 of the recent Explanatory Memorandum to the YFYS Bill[5] 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 incur 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.

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[5] Explanatory Memorandum available at *Treasury Laws Amendment (Your Future, Your Super) Bill 2021*, aph.gov.au. Available at: https://tinyurl.com/5wa7ybfz (Accessed: 19 April 2024).

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 in the years close to 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 note that it is possible for a fund to provide two investment options that are intended to be very similar. One may be used for accumulation interests and the other for pension interests. Hypothetically, it is possible that the investment option in the accumulation phase might have been ordered by APRA to be closed to new members due to failing the performance test, yet the mirrored pension option would be able to remain open for existing and new investors.

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 and further analysis by Treasury in addition to the discussion contained in the Consultation Paper.

For reasons that we have explained in a previous Treasury submission[6] we do not agree with the statement in the Consultation Paper that "without longevity products, concern about running out of savings contributes to retirees underspending and experiencing lower standards of living in retirement".

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 or their employers.

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

[6] CA ANZ and CPA Australia (2024) *Submission on Improving consumer experiences in Australia's retirement system*. Available at: https://tinyurl.com/uannysty [Accessed: 16 April 2024].

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.