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Retirement Income Policy Division
Treasury
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Subject: Your Future, Your Super

Dear Sir/Madam

Thank you for the opportunity to comment on the draft legislation and explanatory material relating to the Government's Your Future, Your Super package announced in the 2021-22 Budget.

Who is Mercer?

Mercer is one of the world's leading firms for superannuation, investments, health and human resources consulting and products. Across the Pacific, leading organisations look to Mercer for global insights, thought leadership and product innovation to help transform and grow their businesses. Supported by our global team of 22,000, we help our clients challenge conventional thinking to create solutions that drive business results and make a difference in the lives of millions of people every day.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $150 billion in funds under administration locally and provide services to over 2.4 million superannuation members and 15,000 private clients, including the Mercer Super Trust, which has around 220 participating employers, around 190,000 members and more than $24 billion in assets under management.

Overall response

Mercer supports:

- The introduction of single default to reduce the number of multiple accounts and improve the efficiency of the superannuation industry
- The development of a consumer-friendly database and comparison tool to provide fair and simple information to assist individuals choose the best superannuation fund for them

- The introduction of performance tests overseen by APRA to improve the quality of superannuation funds and so improve member outcomes
- Improved clarity regarding the need for fund trustees to always act in the members' best financial interests

However, Mercer recommends further development of the announced policies to ensure improved member outcomes from these changes by recognising:

- The need to improve the performance tests to realistically accommodate a broader range of asset classes
- The need to recognise differing volatility (risk) that exists between different asset classes held by superannuation funds
- The suggested penalty for failing the proposed performance test is likely to adversely affect disengaged members more than any other stakeholders which represents an unfortunate outcome
- The need for the comparison tool to allow for several features of superannuation, as suggested by the Productivity Commission (PC)
- The important role that insurance in superannuation provides for many Australians and that the need for this benefit can change significantly during one's working years
- The initial MySuper comparison tool should focus on members aged 45 to cover members up to age 50, where their needs are more homogenous than at older ages, as well as enabling fair comparisons between lifecycle and balanced funds
- The critical role that major employers can play to encourage increased competition within the superannuation industry and so provide enhanced member outcomes throughout the whole industry

Urgent need for Regulations

The current draft Bills are very light on detail in some areas and therefore do not represent the likely practice or outcomes that will occur within the superannuation industry and thereby affect fund members. For example, the Regulations are expected to:

- Define a 'stapled fund'
- Define 'trustee directed products'
- List the benchmark indexes that will be used in the performance tests
- Contain the timing and further details of the related consequences for funds that are deemed to be underperforming
- Define the form and details of the notice that underperforming funds will need to send to their members

To enable the industry to better understand the operations and implication of these Bills, it is essential that the draft Regulations be available for a significant period of consultation before these Bills are presented to Parliament.

Single default

Mercer considers there are limitations of the 'stapled fund' approach which need to be recognised and considered in its implementation. These include:

- A reduction in competition within the superannuation industry as many individuals will stay with their stapled fund upon changing employers. While such a result will reduce the number of multiple accounts, this simplified approach may significantly reduce member and employer engagement and therefore reduce competition, which is not a desirable outcome in the longer term.
- The death and disability insurance cover provided by the "entry fund" may not be suitable for many members later in life. When the member joins their first fund, they are unlikely to have insurance or be concerned with the insurance cover provided by this fund. However, as their working career develops and personal circumstances change, insurance cover is likely to become more important. Hence, Mercer believes there needs to be nudges or triggers in the process to encourage individuals to review the provision of insurance when they change jobs. This is particularly the case for those who move to work in more risky industries (e.g. dangerous occupations) where cover restrictions may apply or additional cover is needed. Alternatively, others may move to less risky jobs (e.g. professional services) where considerably lower insurance premium rates may be available.
- Employer-supported superannuation has many advantages for members as larger employers can use their scale to secure better superannuation arrangements for their employees. Some employers will wish to continue to use superannuation as a benefit to attract or retain staff, whether through contributions above the SG, subsidised insurance, reduced fees or additional employee services. There must remain an opportunity for employers to highlight these benefits when on-boarding new employees and that such information does not constitute financial advice or fall foul of anti-hawking or design and distribution obligations laws. Indeed, Treasury's Post-implementation review of Tailored MySuper in October 2015 noted that: "The scrutiny of any particular employer that is brought to bear on the MySuper product will benefit all members". The role of employers will continue to be important to maintain competition in the industry.
- Many members will remain with their first fund due to inertia. Whilst this will reduce the number of multiple accounts, it may not be the best outcome for them. Hence funds will need to be able to promote their features and performance and thereby encourage member choice.
- Many funds will see fewer new members after the single default reform is introduced. This is likely to lead to an increased number of fund mergers. However it is also likely to create some "orphan funds" that are unattractive merger partners for the remaining funds resulting in a poor outcome for the remaining members of these orphan funds. Hence, the regulations must provide a simple mechanism for fund mergers without either fund incurring significant costs.

In light of the above comments, Mercer recommends that:

- Employers should be encouraged to nominate an employer-preferred superannuation fund[1] and be able to inform new employees of the features of this fund which they could choose to join, whilst also transferring their accumulated superannuation balances to this fund.
- Insurance is recognised as an important benefit for many employees and that:
    - Some industries are higher risk (eg military) and different insurance arrangements than provided in a new hire's stapled fund may be more appropriate
    - Some employer-preferred superannuation funds are likely to have cheaper insurance due to their membership base and this fact should be able to be identified easily to new employees
- Mergers between funds should be encouraged, including ensuring that a transfer-in of a poorly performing fund does not adversely affect the performance test result of the better performing fund.

'YourSuper' comparison tool

The Government wants to encourage members to be able to choose the best superannuation product for them, which implicitly recognises that their current or initial "entry fund" may not be suitable throughout their working years.

The proposed comparison tool for MySuper products is deliberately simple and will show investment returns and fees, updated on a quarterly basis. Underperforming products, as determined by the annual performance test, will be highlighted in the comparison tool.

As currently proposed, there is no mention of insurance which suggests that the insurance costs and benefits would be similar for all products. This is not the case as has been highlighted in a recent ASIC Report. Insurance remains a valuable benefit for most superannuation fund members.

Indeed, the PC suggested that their proposed MySuper elevated outcomes test should cover the following items in respect of each superannuation fund:

- Administration
- Insurance
- Investment strategy
- Advice

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[1] We have used the term 'employer-preferred fund' rather than default fund as the importance of default funds is likely to reduce with the introduction of stapled funds as individuals will need to choose to join a new fund after their initial employment i.e. for new hires with a stapled fund, their default fund will be the stapled fund rather than the employer's default fund, so it would be confusing to communicate the employer fund to them as being the employer's default fund. In this context, it is important that employers be able to nominate an employer-preferred fund to be shown as an option during the ATO portal on-boarding process of new employees.

- Member services
- Scale

That is, any comparison tool should go beyond a single metric or two such as investment performance or fees. APRA also recognised this fact when designing its *Superannuation Prudential Standard SPS 515 – Strategic planning and member outcomes*, as did the changes to the SIS Act which introduced the annual outcomes assessments.

Although MySuper products are default products, trustees have the responsibility to act in their members' best interests; hence no two funds should be the same. There will be differences and these differences should be encouraged to foster competition and strengthen Australia's superannuation system.

Issues with the comparison tool, as currently proposed, include:

- No inclusion of insurance costs and benefits, recognising that funds have different insurance designs and different premiums for the same insurance cover
- Double counting of investment costs if these costs are shown as part of fees and also used to reduce gross investment returns
- Difficulties in allowing for lifecycle funds, which are recognised around the world as the best approach to de-risking for members approaching retirement, as by design they have several cohorts of members (with different investment strategies) which makes a single composite net investment return for the product meaningless for any individual member
- No allowance is made for the investment risk profile for the individual member, which often varies by age
- No allowance is made for fee reductions negotiated by employers or for additional contributions made by some employers to their selected MySuper product
- No allowance is made for the options, benefits and services provided by some products e.g. intra-fund advice

The development of this comparison tool could indirectly stifle innovation as the metrics used in the tool will drive the behaviour of trustees and the ongoing design of superannuation funds. In the rush to contain or reduce fees in order to be competitive, member benefits and services are likely to be reduced.

It should also be noted that ASIC requires a superannuation fund's promotional material that cites past performance figures to include a cautionary note along the lines that past performance is not a reliable indicator of future performance. It will be important therefore, that the comparison tool does not imply that a better performing fund over the last period will continue to perform better in the future. This is not necessarily true! For example, a top performing fund for the last eight years may have a below median performance in the next year.

These comments do not imply that a consumer-based comparison tool should not be developed. A well designed and comprehensive tool will help consumers. However, it needs to be recognised that all consumers are not concerned with the same metrics. Superannuation is more complicated than that.

A superannuation comparison tool needs to be developed carefully recognising different consumer preferences and that future investment outcomes will not necessarily reflect the past. For example, it would be helpful to rank the relevant funds for each consumer based on personal answers to three or four simple questions such as:

- The individual's age
- The individual's total balance, which could be obtained directly from the ATO data
- The individual's desire (or otherwise) for insurance
- The individual's willingness to accept variation in their future investment return

In respect of the Your Super comparison tool, we recommend that the initial tool for MySuper products should apply to the benefits and services offered to members under the age of 50, say at age 45. This approach has several advantages:

- Members under age 50 are much more homogenous in their needs and expectations than older members. In brief, they are all in the accumulation stage and most have not yet started to plan for retirement.
- Job changes are much more frequent under age 50 than at older ages. Hence, the Your Super comparison will be more relevant at younger ages.
- Most of these younger members in a particular fund have the same (or very similar) investment allocation, whether the fund has a life cycle or balanced investment approach.
- Most of these members have insurance needs whereas some older members do not need insurance.
- Many of these younger members have not yet engaged with superannuation so that a stronger oversight of the default system is more desirable. In contrast, many older members take a stronger interest in their superannuation as they approach retirement and may decide to change their investment allocation.
- Age 45 is at or near the halfway point in most individual's working careers.
- This approach would considerably simplify the initial development and understanding of this tool, which could then be expanded later following consumer experience.

If one limits the initial comparison to members at age 45, we believe it is feasible to construct a comparison tool of MySuper products that shows past investment performance, insurance premiums for a fixed level of cover of death and TPD, and administration fees for particular balances.

Finally, it is important that the comparison tool provides clear explanations to those using the tool. That is, it should also be seen as an educational opportunity to help individuals increase their understanding about superannuation. This is common practice with most consumer-based comparison tools.

Performance test

As indicated above, Mercer supports the introduction of a performance test. However, this test can be improved in several ways, as discussed below:

Benchmark Indexes

A broader range of more tailored and relevant market-related indexes than set out in the Budget paper should be used to recognise the range of assets held by superannuation funds. In particular, we suggest the following unlisted asset indexes:

- Domestic (unlisted) private equity: AVCAL Australia Private Equity and Venture Capital Index
- International (unlisted) private equity: Cambridge Associates Global Private Equity Index
- Domestic Unlisted Property: Mercer/IPD/MSCI Australia Property Fund Index Core Wholesale
- International Unlisted Property: Mercer/IPD/MSCI Australia Property Fund Index Core Wholesale
- Domestic Unlisted Infrastructure: MSCI IPD Australian Unlisted Infrastructure
- International Unlisted Infrastructure: MSCI IPD Australian Unlisted Infrastructure

These indexes were used by the PC in respect of BP2, their blended benchmark portfolio which they acknowledged was more representative of superannuation funds' exposure to unlisted asset classes, and thus more closely represents how funds actually invest (in terms of implementing their asset allocations). BP2 was used throughout the PC's report.

In addition, we suggest additional indexes should be used in respect of high yield assets and emerging market debt. Many superannuation funds have meaningful allocations to these assets and therefore to avoid "gaming" through the use of inappropriate indexes, we suggest the following indexes:

- High yield: ICE BofAML Global High Yield Index
- Emerging market debt: JP Morgan GBI EM Global Diversified

The introduction of a second test

We are concerned that under the proposed performance test, some superannuation funds may fail the test if they have taken decisions to protect their members' best financial interests; for example, by de-risking in an over-inflated market. This is similar to a type 1 error in statistics where a false positive occurs or "an innocent person is convicted".

We therefore recommend a second test be developed for funds or products which fail the initial test. This approach should reduce the probability that good performing funds or products are deemed to be under performing, which can occur under the current proposal.

We recommend using a risk-adjusted measure as this will allow for deviations from the benchmark that have been made for risk management purposes. We also note that the only other performance test of this kind in the world, as far as we are aware, is in the Netherlands and their test recognises there will be different market volatility between fixed interest assets and real assets (their terminology). In short, their formula recognises that there will be greater deviations from the benchmarks as the percentage of real assets in a fund increases.

This second test could use the Simple Reference Portfolio or the Strategic Asset Allocation benchmark from the APRA Heatmap as they provide a simple benchmark to assess performance that is suitable for the long time horizon of superannuation. The benchmark asset allocation could be based on each product's experienced volatility of returns as a proxy for risk over the same time horizon. This will better allow for investment decisions that have been made to protect members from downside risk.

The consequences of failing the test

The current proposal is that all members holding the underperforming product be informed when a superannuation product fails the proposed test. This member communication is likely to lead to a 'run' on the fund by the more engaged members leaving the disengaged members to bear the consequences of the failure. That is, the very cohort of members that the Government is seeking to protect are likely to suffer.

We suggest it is much better if the fund or trustees are affected, rather than the members. That is, the consequences of underperformance should affect the governance of the fund and not adversely affect the remaining members.

Therefore our suggestion is as follows:

1. Upon the first failure of both tests, the fund must implement an Action Plan. Some possible components of this Plan could include:
    a. The appointment of an independent chair of the trustees
    b. The tendering of certain outsourced services, where they are causing underperformance
    c. The review of relevant investment managers
    d. Regular monitoring by APRA
2. Upon the second failure of both tests, which should be two years after the first failure, thereby giving the Action Plan time to work, there would be a compulsory Successor Fund Transfer. It is noted that the receiving fund should be protected from the consequences of receiving the poorly performing assets from the failing fund.

Other matters

The proposed consequence of failing the annual performance for two consecutive years is that the MySuper product is no longer able to accept new members from the day the notice is given. This seems unworkable and the explanatory material does not shed any light on how the notice-giving process will allow time for preparation for closure of the product by the fund and, if it is a MySuper product, all employers for whom the fund is their default fund.

If this MySuper product was a default fund for an employer, the implication is that the employer must choose a new default product for new employees who commence after the day the notice is given (or who joined the employer in the prior month/s but have not yet become members of the default fund) and do not have a chosen fund or a stapled fund from previous employment. The selection of a default superannuation fund, through an industrial award, EBA or tender process, normally takes several months. Hence it is not practical for a new default fund to be selected within weeks of the notification being received by an employer.

If adequate time is not provided there are likely to be adverse consequences for members and employers, including:

- for employers, dealing with the 'bounceback' of SG contributions for new hires and potentially becoming liable for SG charge and penalties where the employer is unable to (i) select another default fund, (ii) set up to pay contributions to that fund, and (iii) actually pay the contributions into that fund before the SG contributions deadline;
- for rejected new members, potential loss of investment earnings and delayed commencement of insurance cover (during which time a claim event could occur).

It is therefore recommended that the time spans relating to the closure of a product to new members be lengthened.

Best financial interests

As noted earlier, Mercer supports clarifying the role of trustees, where necessary. However we consider that most superannuation fund trustees already well understand their responsibility to act in the best interests of their members – when exercising their powers and performing their duties – as they are already required to do so expressly under law. That is, one of the central and non-negotiable statutory covenants under the Superannuation Industry (Supervision) Act 1993 requires a corporate Trustee and each of its directors to live up to a "best interests" statutory standard and to be held to account if they do not do so.

The current proposal is a subtle change requiring trustees to act in all cases in the best *financial* interests of their members. A possible outcome of this development is that it could impede expenditure on the development of new products or services (for example in the retirement benefit phase), particularly if these innovations were not going to be used by a majority of members. Such an outcome may limit innovation and competition within the superannuation industry. We therefore recommend that clear guidance is needed so that research and product development are encouraged and it is clear that such expenditure would not be prevented by this proposed change.

We would be pleased to discuss any aspect of this submission with you. Please contact me on [redacted] or by email to [redacted] to arrange a discussion.

Yours sincerely,

Dr David Knox
Senior Partner