14 October 2022

The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

Your Future, Your Super Review: Consultation paper

The Actuaries Institute ("the Institute") welcomes the opportunity to comment on the issues raised in the Your Future, Your Super Review Consultation paper – Proposals for Reform dated 7 September 2022. The Institute is the peak professional body for actuaries in Australia. Our members have had significant involvement in the development and management of superannuation within Australia.

We provide in the Attachment to this letter our detailed submission responses to the consultation questions relating to the unintended consequences arising from the Your Future, Your Super measures where our members have expertise. This is particularly around the Performance Test, YourSuper comparison tool and longer-term impact of stapling.

You will see that we continue to have major concerns regarding the Performance Test. As outlined in our submission to Treasury on the draft Performance Test Regulations in 2021, we believe the Performance Test assessments are not sound for their intended purpose. The Performance Test as introduced:

- Fails a "pub test", as products with above average net returns can fail the Test;
- Focuses on implementation of strategy not outcomes, meaning products with an almost identical risk profile and net returns can have a very different Test result;
- Does not consider risk;
- Requires trustees to manage shorter-term tracking error against benchmarks, thereby constraining investment decisions, and potentially reducing member outcomes; and
- Has greater consequence and hence greater priority than other measures which focus on member outcomes such as the annual outcome assessments.

We recognise the difficulty in suggesting a replacement test that addresses all of the above issues in a readily understandable manner. We therefore suggest that a practical solution is for the consequences of failing the Test to be modified so that it becomes one of the key member outcomes tests monitored by superannuation fund trustees, not the key test in isolation.

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The Institute would be pleased to discuss this submission. If you would like to do so, please Chief Executive Officer of the Actuaries Institute.

Yours sincerely,

President

Attachment

Your Future, Your Super Review Consultation Paper

Responses to Consultation Questions

Performance test

Test methodology

1. **Does the measurement of *actual return* using strategic asset allocation affect risk-taking behaviour by superannuation trustees?**

   The Annual Performance Test (the Test) does not measure member outcomes, but instead how well a trustee has implemented a product's investments based on benchmarks related to the product's published strategic asset allocation. The implementation of investment strategy is of less importance to determining member outcomes (i.e. actual return for members for an appropriate level of risk) than the investment strategy itself.

   Given the significant consequences of failure, passing the Test has become a new investment objective.

   We have witnessed that this has affected risk-taking behaviour by superannuation trustees, as the ongoing viability of the fund is dependent, in part, on products passing the Test. Therefore, trustees are actively seeking to manage the risk that their products fail the Performance Test. Circumstances arise where this is at odds with member outcome metrics such as total expected return for a total expected risk.

   As the Test measures actual returns over a rolling eight year period, superannuation trustees' investment decisions will be influenced by whether or not a proposal improves the probability of passing the Test in the short term. A Trustee may not proceed with an investment decision even if it improves longer term member outcomes if it detracts from the likelihood of passing the Test in the short term.

   Where actual returns have been poor relative to the benchmark return over the past Test look-back periods, superannuation trustees may not have the appetite to maintain investment strategies that have contributed to this underperformance (e.g. being overweight in small cap equities relative to ASX 300, or a dynamic asset allocation tilt away from fixed interest). However, market conditions can change over a longer cycle, and a Trustee decision to exit a strategy, effectively crystallising underperformance against the benchmark return, will deliver sub-optimal member outcomes should the strategy become more favourable over time.

2. **Does the current set of indices used to calculate *benchmark returns* unintentionally distort investment decisions or reduce choice for members? If so, is there a way to adjust the benchmark indices while maintaining a clear and objective performance test?**

   The current set of indices will reduce choice for members as they constrain investment strategies to those most effective at managing tracking error against these benchmarks. The Test promotes portfolios designed to pass the Test even if they may have lower expected returns, be less effectively diversified, and bear more risks in terms of absolute volatility. Conversely trustees will be more reluctant to invest in portfolios less aligned to the

Test, even when they may be expected to produce better longer-term outcomes. ESG investments are an example, where the expected pay-off period may be longer than the eight years of the Test (and where the investment strategy may also better meet members' preferences than the Test benchmarks). Recent research by the Conexus Institute[1] estimates the opportunity cost to consumers in the form of lower expected returns is $3.1bn per annum.

In the medium-term it is possible that the Test will lead to the asset portfolios of each MySuper product being materially the same, create a barrier to investment in newer asset classes such as projects of national significance and private equity/venture capital/early stage innovation investment, reduce choice for members and increase contagion risk and market volatility. An expansion of the current set of indices may help to mitigate these unintended outcomes but would need to be managed carefully given any change to indices will impact on past Test results.

Importantly, we recommend that in addition to a review of the indices, the Test be modified so that it is incorporated as one of the annual member outcomes tests monitored by superannuation fund trustees, not the key test in isolation. Members can be informed by the key member outcomes tests while still having a similar level of investment choice.

3. **Does the calculation of *actual RAFE* and *benchmark RAFE* discourage non-performance related product features that members may value (such as customer service or platform products)? If so, can this be addressed without diminishing the test's focus on performance?**

In a similar vein to the impacts on investment portfolio decisions, we believe the RAFE-related measures are impacting on trustees' ability and willingness to invest in product, system, service and administration enhancements that would otherwise improve a suite of longer-term enhanced member outcomes.

Further, we are concerned that the RAFE measure ignores employer scale discounts and employer fee subsidisations that apply to some member cohorts within a product. This can lead to cohorts being advised they are in an underperforming product when it is not the case for members receiving employer-related fee reductions.

The RAFE measure will discourage the maintenance and continued enhancement of non-performance related product features where they are not directly linked to helping the products pass the Test in the short term. We believe that enhancement of features such as education, intra-fund advice and tools can promote better member decisions that lead to better longer-term member outcomes.

The concerns regarding the RAFE measures are material because of the greater priority that superannuation trustees now must place on the Test. Should the Test be part of a broader set of key member outcome tests, the RAFE measures are less likely to discourage innovation of non-performance related product features.

This concern is particularly important when the Test extends to non-MySuper products.

[1] Conexus Institute – https://theconexusinstitute.org.au/wp-content/uploads/2022/10/YFYS-Sustainable-tracking-error-re-visited-20221012-final.pdf

4. **What are the longer-term impacts of the performance test on market dynamics and composition? How will these factors impact on long-term member outcomes?**

The significant consequences of failing the Test means it will be the most critical investment objective for a superannuation fund trustee. As has been seen from the first round of failures for MySuper products, the majority of superannuation funds with failed products have now merged (or are merging) with other funds.

Given the Test is now known, monitored and built into trustees' investment objectives, the likelihood of MySuper products failing the Test in the future is very much reduced. We therefore expect that the Test will not lead to as many mergers of remaining superannuation funds in the future.

Going forward, we believe other broader measures of comparative member outcomes (such as the SPS 515 requirements and the APRA Heatmaps), coupled with APRA's increased directive powers, are more likely to lead to changes to the composition of the market. Given this, and as the Test does not directly measure member outcomes, a diminished focus on the Test is desirable. For example, the Test could be incorporated it into the broader suite of annual outcome assessment measures as originally contemplated by the Productivity Commission in its consultation paper on efficiency of the superannuation system.

There are other longer-term impacts beyond the superannuation industry and member outcomes. For example, as noted in response to Question 2, the current Test is expected to reduce investment in asset classes that produce member outcomes over a longer time period but with more volatile returns, e.g. ESG and private equity/venture capital/early stage innovation investment. This will have structural impacts for the wider national economy.

Consequences of failure

Consultation questions

5. **Is there evidence to indicate that the notification and website publication requirements have been effective at encouraging members to consider, and switch to, alternative products? Are there ways this could be improved?**

Notifications sent to date have been to MySuper members, which will include higher proportions of disengaged members than in Choice products. Having 10% of members switching to alternative products could be regarded as a success given this disengagement.

Noting that effective communication with disengaged members will always be problematic, there are nevertheless some key changes that we believe should be made to the existing prescribed notification requirements to make them more effective, including:

- Members often hold more than one investment option in a fund, yet the prescribed notification refers to the member's total account balances.

- There is no clear communication on the potential consequences for the member's insurance coverage.
- There is no reference to non-MySuper products potentially being more suitable for a member depending on their risk preferences.
- As with all other notifications trustees issue to members which mention investment, it should include a past performance warning.
- The notification refers members to the YourSuper comparison tool, which measures performance differently (it uses actual net return) and shows that an "underperforming" product under the Test can have better returns and lower fees than alternative products. Whilst the YourSuper comparison tool can help with MySuper product selection, it also has its limitations (see our response to questions 10 to 12 below).

6. Have the consequences been effective at encouraging trustees to improve their performance or merge with better performing funds? Are there ways this could be improved?

The Test has led the majority of funds with MySuper products that failed the Test to merge with other funds. If the aim was market consolidation, then the Test has been effective to date.

However, a MySuper product that fails the Test is not necessarily an underperforming product in the way that a layperson would understand this (i.e. relative net return for a comparable level of risk). Some of these funds were not badly performing funds other than under the Test metric, and so it is questionable whether members of those funds will necessarily have improved member outcomes.

In fact the Test has resulted in diminished short-term member outcomes for many members – those members of funds (such as Christian Super) which failed the first Test and then produced market leading returns in the following year. Members of these funds would have missed out had they switched funds after receiving the Test letter.

The most significant impact on encouraging trustees to improve performance from a member outcomes perspective has been the impact of the Test on reducing comparative administration fees. This reflects the more immediate impact amending fees has on the Test outcomes, and has been to the benefit of superannuation fund members.

7. Are the measures in place to resolve underperformance sufficient given the potential for members to be stapled to these products? How can the system best support members in underperforming products?

The SPS 515 and annual member outcomes requirements are a holistic and effective way of identifying and addressing MySuper product underperformance. The requirements placed on trustees under SPS 515 mean that a trustee must take action to address underperformance or seek to move members to an alternative MySuper product. We believe these measures, coupled with APRA's supervisory powers, are sufficient to protect members in underperforming products now that the Test has achieved its purpose of lifting performance expectations.

Product coverage

Consultation questions

8. **Are there any significant issues to be expected when the test is extended to TDPs? If so, how could these issues be addressed?**

   Many types of products are consistent with the definition of TDPs. A typical "balanced" or "growth" diversified portfolio could be suitably included in the Test as the applicability of the benchmark indices and the issues regarding the indices should be no different to MySuper products.

   However, there will be significant issues for other portfolios that may not necessarily create a buffer for the Test even when they may produce better longer-term outcomes, such as ESG investments.

   Members that wish to choose portfolios that include broader ideological principles that do not fall into the definition of faith-based products will also find their choice limited should these portfolios be within the scope of the Test.

9. **What would be the impact of extending the current performance test to other Choice products (such as single sector or retirement products)? How could any issues be addressed?**

   The issues relating to extending the Test to TDPs are applicable to Choice products that are not Trustee directed. In addition single sector portfolios that track to a different benchmark may no longer be offered as they are too "risky" relative to an unrelated benchmark.

   For retirement products, introducing the Test will be at odds with requirements contained in the Retirement Income Covenant and member priorities relating to the provision of retirement income including balancing the competing objectives of maximising income, stabilising income and allowing flexibility to access funds. The current Test does not include any allowance for risk or different objectives. Given the immaturity in this product space, regulations should be less prescriptive to encourage innovation. An approach where the Test is part of a suite of key member outcome tests (considering the retirement income objectives for income, risk and flexibility) is less likely to discourage superannuation trustees from designing or enhancing retirement products.

YourSuper comparison tool

Consultation questions

10. **Does the comparison tool adequately inform members and prompt a behavioural response? Is the tool effective at informing new employees of their options when entering the workforce, including those who do not have an existing superannuation account?**

    The Institute supports the initiative of an online comparison tool to help members compare superannuation funds. We believe the current tool is powerful and persuasive. However, we are concerned that the tool, in its current format, does not adequately inform members and has the potential to mislead members.

    For new employees in particular, who tend to be younger in age and would likely prioritise high returns, the lack of a risk measure and the constraint of an eight year net investment return period may prompt uninformed comparisons between superannuation products, and result in sub-optimal outcomes.

New employees may be unaware of the risks and volatility potentially associated with higher returns. In addition, the eight year net investment return period is generally not long enough to appropriately reflect long-term performance, which is particularly relevant for new employees entering the workforce.

The Institute offered its help to the Australian Taxation Office and the Government in a letter dated 21 January 2022 which contained suggested amendments to the comparison tool to improve its effectiveness while keeping it simple and clear to understand for users. Key suggestions particularly relevant to new employees entering the workforce included:

- The addition of a growth asset allocation (risk) measure; and
- The extension of the eight year net investment return period to a twelve year net investment return period as more data is collected over time in order to appropriately reflect long-term performance of the product offerings.

The letter also attached a "mock-up" spreadsheet detailing the areas of suggested changes to the current comparison tool. We further refer to the contents of the letter and spreadsheet in our responses below.

11. To what extent would altered or additional metrics, or improved functionality, make the tool more effective while ensuring it remains simple and clear? What more can be done to ensure that new employees are able to choose high-performing superannuation product that are appropriate for their needs?

The Institute has been concerned that the simplicity of the YourSuper comparison tool is at the expense of its effectiveness. Our letter to the Australian Taxation Office of 21 January 2022 detailed suggestions to improve the effectiveness of the comparison tool. The key features of our suggestions are:

- Separating the disclosure and comparison of investment and administration fees (for clarity around disclosures);
- Initial default ranking by net investment performance instead of fees;
- Addition of a growth asset allocation (risk) measure; and
- The addition of the standard past performance risk warning, which is required everywhere else in the industry.

12. As the test is applied to more superannuation products, should the comparison tool also be extended? Considering the volume and complexity of Choice products, how could the tool be extended in a way that is meaningful and digestible to members?

The Institute supports the extension of the comparison tool to include Choice products. A large proportion of members in the industry are invested in Choice products, with limited ability to compare these. The extension of the tool to cover Choice products would empower members, particularly those invested in underperforming products, to seek and achieve better outcomes.

Our letter and spreadsheet detail suggestions on how the current comparison tool could be extended and improved to cater for the inclusion of Choice products.

Given the volume and complexity of Choice products, the key features of our suggestions are:

- Reducing the number of products shown by adding a filter to present only the "relevant" groups of products by requiring members to consider the underlying risk level appropriate for their circumstances. For example, if members were prompted with a simple question and indicated that they were likely to need to access most of their money within the next five years, then they could be guided to a smaller group of products or options with lower risk levels.
- Disclosure of investment risk becomes increasingly important as Choice products will widen the range of investment risk from cash to equities. Our suggestions include adding the growth asset allocation and investment strategy of products to provide members with a measure of investment and diversification risks.

Stapling

Consultation Questions

16. What is the actual, or likely, impact of stapling on insurance coverage?

The impact of stapling on insured death and disability benefits is gradual as:

- Existing employees remain in their current fund and stapling will not have an impact relative to the previous default fund system until they change employment.
- New employees to the workforce will continue to join the same fund they would have under the default fund system. Because of Putting Members' Interests First (PMIF) restrictions relating to age and account balances, these members do not receive automatic cover, and most will have no cover for an extended period.

The legislation has only been in place for a bit over a year, so only a small proportion of members are currently in a fund that is different to the fund they would have been in under the default fund arrangement. However, we anticipate there will be a number of insurance impacts over time, as follows.

[1] Insurability and full coverage

Occupational exclusions

Whilst trustees and insurers have taken steps to minimise the application of occupational exclusions, some funds exclude or restrict cover for some members e.g. those working in high-risk occupations. If a person is stapled to one of these funds they will not receive cover if they move to an excluded occupation, yet may well have received cover in their employer's default fund.

Restricted or declined cover

Stapling, combined with the Performance Test and the YourSuper Comparison tool, results in a higher proportion of members changing superannuation fund through choice, which increases the number of new members joining a fund outside the insurance eligibility window for unrestricted automatic cover compared with the pre-stapling environment. This increases the prevalence of restricted or declined cover in the superannuation system and particularly in funds that attract new members other than through the stapling process.

Members subject to restricted or declined cover may have their future insurability impacted as they may have to disclose this when they apply for cover with another fund or insurer.

[2] Membership profile changes

The impact of membership profile changes on the terms of insurance coverage is very gradual under stapling unlike the impact of PMIF and Protecting Your Super (PYS).

Occupation

Stapling means that the occupational mix of a superannuation membership becomes more diverse (and less aligned to a specific industry sector). Over time, it is likely that all funds including single industry sector funds will need to provide occupational categories for insured benefits even for basic levels of cover. This will add a layer of complexity to the insurance designs of these funds that was not previously required.

Growth Rate and Age Profile

Stapling impacts the growth rate and age profile of the insured membership.

- For those funds which attract high proportions of members as they enter the workforce, stapling will increase retention rates (as fewer members leave when they change their occupation/employer), while new member rates will be unchanged. These funds will have higher growth rates than they have in the past and an older average age.
- For other funds new membership growth is significantly impacted by the replacement of the default fund system with the stapling system. Membership will reduce and become older on average over time (assuming the fund takes no new actions to attract members lost through the cessation of the default fund system).

The changing membership profile of funds (occupation, growth rate and/or age) will be very gradual and may over time impact (up or down) the premium rates and/or cover levels of members compared with the pre-stapling environment.

[3] Tailored corporate superannuation arrangement

Employees of many medium to large size corporates receive the benefit of tailored insurance cover under their employer sub-plan within the superannuation fund. This not only results in lower premiums but also more tailored cover, better meeting member needs, as the member's salary and occupation are known by the fund. Indeed, some employers partially or fully subsidise the employee's premium.

Benefits are only available and provided on an automatic basis on the assumption that the majority of employees join the arrangement. Stapling impacts this assumption and over time insurers are likely to become less willing to provide the same level of automatic cover.