GRATTAN Institute

Refine and protect: why the Your Future, Your Super reforms shouldn’t be watered down

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Overview

We welcome the opportunity to contribute to the *Your Future, Your Super* Review. Superannuation is compulsory, complicated, and has a long-term payoff. The conditions for market failure are obvious. It is inevitable that most members will not be engaged with their super and many won't make good decisions even when they do.

The Productivity Commission's 2018 inquiry into superannuation system performance found that fees were too high, there were too many funds, and that many fund members were left languishing in serially under-performing funds while millions of others had unnecessary multiple accounts. The *Your Future, Your Super* reforms were designed to tackle these problems by implementing key recommendations from the Productivity Commission review.

The centrepiece of the package is the new performance test. Super funds are now required to notify their members if they fall furher than 0.5 percentage points under a net investment return benchmark over eight years. Funds that fail the test for two consecutive years won't be able to accept new members until their performance improves, or they merge.

The performance test, implemented in 2021, has already led to better outcomes for super fund members, with several under-performing funds merging with better-performing ones, and other funds lowering their fees. Members of super funds that failed the first round of the test in 2021 have since seen a 20 per-cent cut in the fees they pay, saving them more than $100 million in fees. The objective nature of the test was critical to achieving these benefits and must be protected. There is scope to refine and improve the test, and any changes that improve its operation without compromising its integrity should be welcomed. But the broad structure of the test must be retained.

The expansion of the performance test to choice products should proceed. The Productivity Commission, and more recently the Australian Prudential Regulation Authority (APRA), found concerning levels of poor performance and high fees in this segment. Creating carve-outs for certain choice products increases the risk that the performance test will be gamed. Product diversity and complexity cannot be a 'get-out-of-jail free' card.

The *Your Future, Your Super* reforms also sought to 'staple' super funds to members as they changed jobs, thereby reducing the creation of multiple accounts. Yet stapling does not appear to be working as intended. The current design of the 'standard choice form' offered to new workers appears to still be creating duplicate accounts. The Australian Taxation Office should redesign the 'standard choice form' to better reflect the policy intent of stapling. Meanwhile, concerns that stapling could lead some workers to lose their default insurance cover if they change occupations can be solved by a commonsense ban on occupational exclusions in insurance policies.

The super industry would prefer to be left alone, or to have the opportunity to convince the regulator that they shouldn't have to change. But too many Australians have already suffered poor outcomes in superannuation for far too long. Maintaining the integrity of the *Your Future, Your Super* reforms will help ensure that won't be the case in future.

Yet more work still needs to be done. In particular, the superannuation system needs a wholesale competitive process for default status. The government's focus should be on implementing the remaining Productivity Commission recommendations, including the 'best-in-show' process for selecting default funds.

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1 The Your Future, Your Super reforms are making consumers better off

1.1 Most fund members need protection

Superannuation is compulsory, complicated, and has a long-term payoff. It is inevitable that most working Australians won't engage with their superannuation, and many won't make good choices even when they do.

The 2010 Super System Review (the 'Cooper Review') and the 2018 Productivity Commission inquiry both concluded that about 60 per cent of members are disengaged and make no active choices.[1] This amounts to nearly 10 million Australians who are particularly vulnerable to poor outcomes in the absence of effective policy interventions.[2] Even for those who do get engaged, the complexity of the system makes high-quality decision-making difficult.

Intervention is clearly justified. In its 2018 review of the super system, the Productivity Commission argued that 'the first line of defence is and should always be the policy settings'.[3]

The evidence suggests policy has historically been inadequate and the effects of widespread disengagement are pronounced. Australians spend more than $30 billion a year on super fees – more than they spend on energy bills.[4]. The Productivity Commission found that fees were too high, there was a long tail of under-performing funds, and there were too many unintended multiple accounts.[5]

The two most important *Your Future, Your Super* reforms follow from Productivity Commission recommendations and directly target these poor outcomes. The performance test aims to protect members from under-performing funds, and stapling aims to protect members from unintended multiple accounts. Any changes to these measures must not undermine these objectives.

1.2 Retaining the integrity of the performance test is critical

The consultation paper for this review correctly emphasised the need to retain the objectivity and integrity of the performance test.[6] The review should seek to make incremental improvements to the existing framework rather than wholesale reforms. The broad framework of tailored benchmark portfolios and peer-group administration fee benchmarking is the best available, and came after many years of consultation by the Productivity Commission, APRA, and Treasury.[7]

The existing test provides a clear and transparent benchmark with defined consequences. Funds know how they will be assessed ahead of time, and they understand what happens when they fail. This makes the regime enforceable and enhances the effectiveness of the regulator.

Introducing subjectivity into the test – such as allowing APRA greater discretion in applying the test – would compromise its integrity and risk recent gains to super fund members. Funds can always find an excuse for their under-performance or high fees, and regulatory risk-aversion suggests this could lead to the policy being toothless. When the regulator does make adverse judgments, these would be exposed to perpetual legal challenges.

1. Cooper (2010, p. 9); and Productivity Commission (2018, p. 260).
2. ATO (2022).
3. Productivity Commission (2018, p. 30).
4. Treasury (2020).
5. Productivity Commission (2018).
6. Treasury (2022).
7. Productivity Commission (2018); APRA (2019); and Treasury (2022).

1.3 The impact of any change needs to be weighed against the test's benefits

Treasury estimated that the performance test could reap $10.7 billion in benefits over the subsequent decade through under-performing funds improving or exiting.[8]

From October 2020 (just before the performance test was announced) to June 2022, the number of MySuper products fell by 19, from 88 to 69.[9] Of the 13 MySuper products that failed the first test in August 2021, 10 have merged or are in the process of doing so. The other three have all reduced their fees (see Table 1.1). Overall, members of the 13 products that failed the first round of the test in 2021 are now paying fees around 20 per cent lower than before the test was announced (see Figure 1.1). This represents a fee saving to those members of over $100 million.[10] For a young worker starting out their career in an underperforming fund, the lower fees they now pay will translate into $20,000 boost to the super balance by the time they retire.[11]

These outcomes represent real benefits to members. A leaner system with fewer, lower-fee and better-performing funds means higher balances at retirement. The Productivity Commission estimated that if the 50 highest-cost funds merged with the 10 lowest-cost funds, the annual savings would be about $1.8 billion.[12]

8. Treasury (2020, p. 11).
9. APRA (2022).
10. This is likely an underestimate of the true fee saving, for two reasons. First, it uses fees charged on a $50,000 balance and the under-performing products tended to have lower balances. And second, it does not account for growth in super funds balances post-merger for it is unobservable for products that merged.
11. Cameo modelling based on a worker at aged 30 earning the median Australian wage of $60,000 a year who retires at age 67, assuming real wage growth of 1 per cent a year and returns before tax and fees of 7.5 per cent.
12. Productivity Commission (2018, p. 355).

Table 1.1: All funds that failed the first performance test have either merged or made changes that benefit members

Fund	Status
AMG (Acclaim)	Continuing with reduced fees; failed second test and is closed to new members
Commonwealth Bank Group Super	Continuing with reduced fees and changes to their investment strategy; passed second test
Colonial First State	Continuing with reduced fees; passed second test
Australian Catholic Super	Merging into UniSuper
AvSuper	Merging into Commonwealth Superannuation Corporation
BT Super	Merging into Mercer by April 2023
Christian Super	Merging into Australian Ethical by early 2023
Energy Industries Superannuation Scheme	Merging into Cbus by May 2023
Maritime Super	Merging into Hostplus
ASGARD	Merged into BT MySuper
BOC Gases Superfund	Merged into EquipSuper
LUCRF	Merged into AustralianSuper in June 2022
VISSF	Merged into AwareSuper in November 2021

Sources: AMG Super (2022), CommonwealthBank Group Super (2021), Colonial First State (2022), Australian Catholic Super (2022), AvSuper (2022), BT Super (2022), Christian Super (2022), EISS Super (2021), Hostplus (2022), Asgard (2021), Equipsuper (2021), AustralianSuper (2022) and AwareSuper (2021).

Any moves to change the test to address unintended consequences need to factor in whether the changes will undermine these benefits. In the absence of demand-driven competition, the system has accommodated hundreds of institutional funds and tens of thousands of investment options. This has created unnecessary complexity and cost.

The existence of unintended consequences alone does not justify policy change. Their magnitude matters too. Changes that work against the tests broader benefits are unlikely to be in members' interests.

Meanwhile, concerns about a future system dominated by funds that are 'too big to fail' are misguided.[13] This terminology typically refers to leveraged entities that would cause systemic problems if they defaulted on their liabilities – a characteristic that does not apply to defined contribution superannuation funds.

1.4 There is more to do to fix super

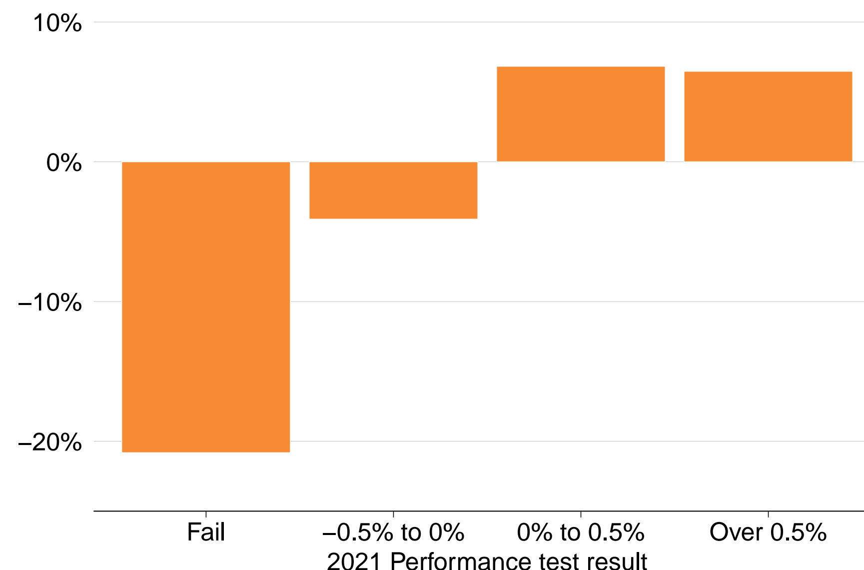
Australians have suffered poor outcomes in superannuation for too long. The *Your Future, Your Super* package represents just one step of several needed to fix these problems.

In particular, the outstanding Productivity Commission recommendation, 'best-in-show', would inject broader, wholesale competitive pressure into the system.

Under the Commission's recommendation, Australians would be defaulted into one of a short-list of 'best-in-show' funds selected by independent experts (although people would retain the right to choose another fund). 'Best-in-show' would improve returns because funds would compete to make the shortlist and stay there.

Figure 1.1: Members in products that failed or nearly failed are paying lower fees

Percentage change in average fees for a representative $50,000 balance member from September 2020 to June 2022, by 2021 performance test result



Notes: Fees include administration and investment fees. Asset-weighted average uses assets as at September 2020. This period includes the transition to the new fee disclosure regime – RG97. It is difficult to unpick the effect of this, but the averages across these broad groups are likely to be indicative of 'true' fee changes. Excludes the 4 products not tested in 2021 and products that passed but did not have a performance test metric reported in the 2021 Heatmap. Products that have merged since September 2020 are matched to the June 2022 fees now charged by the receiving product to reflect the fees paid by members. Mergers planned but not yet completed are not factored in.

Sources: APRA (2022) and APRA (2021a).

13. Wright (2022).

Market discipline would come from experts who have the time, resources and expertise to decide which funds to shortlist, rather than individuals who don't.

The government's focus should be on implementing the remaining Productivity Commission recommendations, not watering down those already implemented.

2 The performance test must be retained but can be improved

Long-run risk-adjusted net returns are what ultimately matters most to members. Broadly, they are a function of investment strategy and implementation. The overarching strategy and level of risk in products is determined by the trustee with regard to their members' best interests. This is a judgment call and it's 'quality' cannot be assessed objectively.

After a thorough consultation process, the Productivity Commission determined that strategic asset allocation benchmark portfolios were the best tool to assess performance consistently and objectively.[14]

While this broad framework remains the best available, any technical changes that improve the operation of the test without compromising its objectivity and integrity should be welcomed.

2.1 There is some scope to increase the number of asset classes

The original Productivity Commission recommendation was for the performance test to be built using investible, listed indexes. Broadly, this test would have assessed funds' value-add via active management, unlisted investments, and dynamic asset allocation. Industry and expert concerns about 'tracking error' discouraging unlisted investments led to the performance test incorporating unlisted indexes.[15]

To further avoid the unintended consequences of discouraging particular investments and reduced diversification, there is scope to add additional asset classes to the test to better match the broad asset classes the funds invest in.[16] New asset classes should be added if:

1. Treasury concludes that a robust, representative index exists for that asset class; and
2. APRA is confident that it has consistently reported data for that asset class.

There is a practical limit to this, however. No benchmark portfolio can perfectly match every investment a fund could make. Rather, the test should aim to reflect the broad asset classes that funds invest in.

2.2 The test timeframe should be extended to 10 years

The current test timeframe of eight years stems from the advent of MySuper data reporting in 2013-14. As more data is collected, the test timeframe should be extended to at least 10 years.[17]

This should also increase the tracking error tolerance of funds, because the individual weight of a bad year would be reduced from one-eighth to one-tenth.

14. Productivity Commission (2018, p. 6).
15. The Conexus Institute (2020). 'Tracking error' refers to a difference between the return of an investment and its relevant benchmark. The concern raised was that using listed infrastructure and property benchmarks for equivalent unlisted investments was inappropriate because the different risk-return characteristics meant the listed index would be expected to deviate substantially from expected unlisted returns.
16. For example, debt is currently benchmarked against an investment-grade bond index, but funds' debt portfolios typically include some high-yield credit, which is arguably a distinct asset class.
17. New years should be added prospectively, rather than the regulator collecting data from before 2013-14.

3 The expansion of the performance test to choice products should proceed

The performance test is scheduled to expand to 'trustee-directed products' in 2023. These are a subset of choice products that include most multi-sector accumulation investment options.[18] This expansion should proceed, to protect members and reduce the number of poor-quality choice products.

3.1 Choice is where the highest fees and worst performance is

The Productivity Commission concluded that there was unhealthy competition in the choice segment, as shown by an excessive number of products ('product proliferation'), poor performance, and high fees. The Commission found that about 36 per cent of choice options analysed were under-performing and that choice product fees were markedly higher than those for MySuper products.[19]

More recent analysis from APRA concluded that more than 60 per cent of choice investment options had under-performed benchmarks, with 25 per cent of options delivering very poor returns. APRA also concluded that fees and costs in choice products were considerably higher than MySuper products, without obvious benefit in financial outcomes to members.[20]

Some argue that there is little justification for expanding the test to choice products given these members have engaged and made active decisions.[21] However, the outcomes outlined above indicate serious market failure because of the difficulties members have in assessing product quality. It is very easy for members to switch from a MySuper product to a choice one, regardless of their financial literacy. Members should not face a regulatory protection 'cliff' after an activity that takes only a few minutes and exposes them to the prospect of even higher fees and worse performance, potentially costing them many thousands of dollars in foregone super savings by the time they retire.

3.2 Carve-outs are bad policy

There is a wide variety of products in the choice sector, even within the subset of trustee-directed products. But this product diversity must not become a 'get-out-of-jail free' card.

Investment options available via platforms and other channels should be subject to the test

The investment options available via platforms and other more sophisticated channels should be included. These are mostly offered by retail funds. The under-performing choice products identified by the Productivity Commission were almost exclusively offered by retail funds.[22] Therefore, a platform carve-out risks leaving some of the worse-performing choice products outside the regime. It would also create a strong incentive for funds to move simpler choice products onto platforms to avoid the test.

Extending the test to platforms presents some challenges. Complex structures mean fees and tax may not be uniform for all members invested the same way. However, it is exactly this complexity that can be used to disguise high fees or poor performance. Depending on the data that APRA observes, an asset-weighted average across the

18. The 'trustee-directed product' definition excludes single-sector options (e.g. Australian shares only), those managed by an unconnected entity, products that give members direct control over investments, and retirement products.
19. Productivity Commission (2018, pp. 22, 148, 181).
20. APRA (2021b, pp. 11–13).
21. JANA (2020, p. 2).
22. Productivity Commission (2018, p. 148).

potential fee 'pathways' that members can experience is likely to be the best option.

An under-performing option offered on a platform may also only represent a small portion of a members overall portfolio, particularly if the portfolio is overseen by a financial advisor. A separate prescribed letter for choice products in the regulations should reflect this. The test and its consequences should still apply, as it will provide a benchmark for platform providers and advisors to consider what is being offered and recommended to clients.

ESG products should be accommodated where it doesn't compromise the integrity of the test

An increasing number of superannuation funds are offering products that target environmental, social, and governance (ESG) considerations. Some commentators have raised concerns that the performance test, as currently designed, discourages ESG investing as practices such as screening out undesirable investments could increase the tracking error for the fund against the existing test benchmarks.[23]

However any changes to the performance test to accommodate ESG investing must not undermine its integrity, and should only proceed subject to the following two conditions being met.

First, the regulations would need a robust, game-proof definition of ESG investment. This is no easy task. ESG language is currently used liberally, and recent ASIC investigations point to the widespread 'greenwashing' currently taking place.[24]

And second, investment benchmarks that reflect that definition would need to be available to assess the performance of ESG funds.

23. For example, see: Taylor (2022).
24. Read (2022).

In the absence of these two requirements being met, any special treatment for ESG options risks creating a regulatory back door for super funds to re-badge their products as targeting ESG objectives in order to avoid the performance test.

A review should assess further expansion of the test

Expanding the performance test beyond trustee-directed products – to single-sector, externally-managed, member-directed, or retirement products – should be subject to a review, as the previous federal government committed to.[25]

In particular, any expansion to retirement products needs careful consideration. Most current retirement offerings are essentially simple multi-sector portfolios that would fit the existing test framework. But the retirement income covenant has introduced broader objectives for trustees to consider for the retirement phase, above fees and returns. Subjecting retirement products to the performance test could create a conflict with these broader objectives.

However, a strong purpose-built regulatory framework for retirement products is still needed. At present, retirement products are regulated more lightly than accumulation, despite being more complicated and the stakes for the member being higher.[26] This risks the proliferation of products of varying quality as a growing number of Australians retire – similar to the experience of accumulation phase products over the past 15 years. This will be the subject of a future Grattan report.

25. Australian Parliament (2021, p. 3133).
26. For instance, many pooled retirement products that manage longevity and other risks are 'one shot' games – once members commit to the product they are unable to leave.

4 Stapling should be fully implemented

Unintended multiple accounts are the costly and unnecessary outcome of a major structural flaw in the superannuation system. The absence of a mechanism that ensured accounts follow members to new jobs allowed the number of unintended multiple accounts to balloon to more than 10 million. This unnecessarily cost members billions of dollars annually in duplicate fees and insurance premiums.[27]

Much good work has been done to reunite inactive low-balance accounts with members and to stem the damage unnecessary fees and insurance can do in the meantime. But stapling is the mechanism that can prevent these problems arising in the first place.

Data on the impact of stapling to date is scarce. But anecdotal evidence indicates that at least some employers are reluctant to change their processes.

Investments to streamline the process will ease the burden on employers, and changes need to be made to the 'standard choice form' issued by the ATO to better reflect the policy intent of stapling. The current design of the form and the flow-on to digital on-boarding services is probably still leading to new accounts being the 'default' outcome when an employee starts a new job.[28] Selecting an existing fund should be easier – for both employers and employees – than selecting a new fund.

Concerns about people starting a new job and remaining in an insurance policy that excludes their new occupation can be addressed by a commonsense ban on occupational exclusions. Such restrictive policies are becoming increasingly inappropriate, particularly given most funds now present as a mass-market offering rather than a industry- or employer-specific fund.

Finally, while not under consideration in the consultation paper, it bears repeating that the industry-proposed model of 'auto-rollover' is inferior. Automatically moving members between funds without their consent would create unnecessary cost and exacerbate disengagement.[29]

27. Productivity Commission (2018, pp. 295–313).
28. The standard choice form still allows new employees to open a new default account by ticking a single box, which then means the employer is not obliged to request details of their existing account from the ATO.
29. Productivity Commission (2018, pp. 303–304).

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