21 December 2020

Alex Maevsky
Manager, Retirement Income Policy Division
Treasury

By email: superannuation@treasury.gov.au

Your Future, Your Super Exposure Draft Legislation

Dear Alex

Thank you for the opportunity to provide a response to the exposure draft legislation and explanatory material for the Your Future, Your Super package.

Rest is a major profit-to-member industry superannuation fund with more than 1.7 million members – or one in seven working Australians – that manages assets of $56 billion.

We are supportive of the intent of the *Your Future, Your Super* reforms, and improving member outcomes through lower fees, high performance and transparency. We agree that poor performing funds should be removed from the superannuation system.

Attached to this letter are two appendices:

1. Appendix 1 – Matters relating to the management of underperformance
2. Appendix 2 – Matters relating to the best financial interests duty

Given the huge impact of the proposed legislation on non-performing funds and their members, it is absolutely critical that the test correctly identifies non-performing funds from those that are delivering strong outcomes for members. The currently proposed underperformance test does not do that.

Rest supports the objective of ensuring that high performing funds manage superannuation for Australians, and the intent of the proposals to establish expectations for superannuation fund performance, and consequences for funds that persistently underperform, but without changes the outcomes will not achieve the Government's policy as well as fundamentally changing the way funds invest and working against the best financial interest of Australian superannuation investors and broader nation building opportunities.

In order to ensure the measures meet the objectives, we propose alternatives to elements of the intended changes, which we believe will improve the effectiveness and remove potential undesirable outcomes if implemented as proposed. Those alternatives are:

1. Include administration fees in the calculation of the performance benchmark, to ensure that benchmarking reflects the impact on members' outcomes in superannuation or the very least include these in the application of the consequences of not meeting a net investment return only measure, and
2. Introduce some modifications to reduce the likelihood that the performance benchmark test incorrectly validates poor performing funds, or alternatively invalidates good performing funds.

Further detail on these alternatives and the rationale is included in the attached Appendix 1. This paper has also been provided to Assistant Minister Jane Hume. Other points regarding the best financial interests duty are included in Appendix 2.

I invite you to contact me directly on [redacted] or via email on [redacted]

Yours sincerely,

Sarah O'Brien
Head of Regulatory Affairs, Rest

Appendix 1 – Matters relating to the management of underperformance

Rest has long supported policy and initiatives targeted at reducing the number of unnecessary multiple accounts, in the interests of maximising member outcomes. We are also strong advocates of transparency to members, and the provision of information that allows members to make informed decisions about their superannuation.

Rest also supports the objective of ensuring that high performing funds manage superannuation for Australians, and the intent of the proposals to establish expectations for superannuation fund performance, and consequences for funds that persistently underperform.

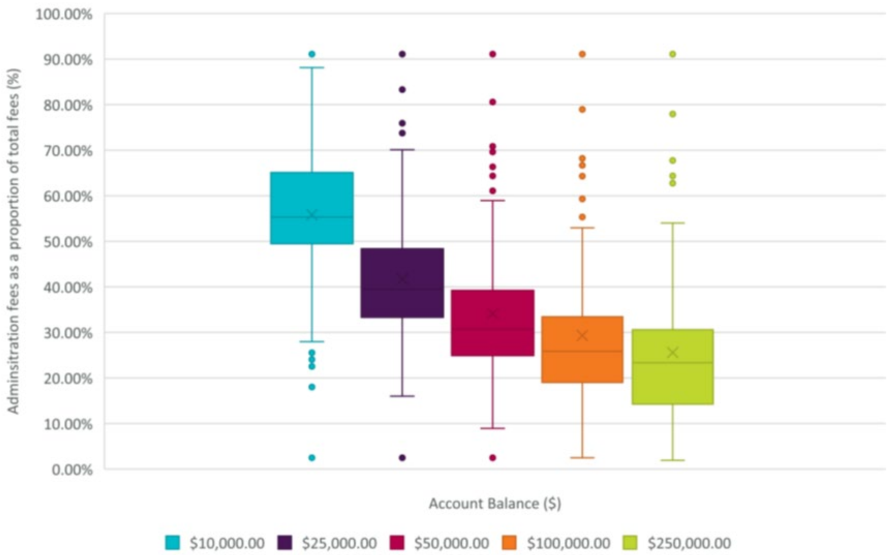
However, the introduction of this legislation in its current form results in a considerable change in the expectations of funds backed by significant regulatory consequences, applied to existing performance over ten years, as established since MySuper commencement. This effectively applies retrospective consequences to investment decisions made by funds in an existing environment. We do not believe that this is a reasonable application, and that therefore our suggested alternatives provide better outcomes for members.

Including administration fees

The current proposed benchmark is based on investment returns net of *Investment fees* only. Investment fees only form part of the impact of fees on member outcomes, for this benchmark to truly drive differences in retirement outcomes it must be the measure of total performance by a superannuation fund and include *Administration fees*.

Analysis conducted by Rice Warner[1] shows that the proportion of a member's total fee which is attributable to administration fees can be as high as 90%, varies significantly in the market and has a significant impact, in particular for younger people and those with lower account balances who are less likely to engage with their super and make choices.

Figure 1: Administration fees as a proportion of total fees by account balance[2]



If a member has a balance of $10,000, administration fees are likely to account for more than 55% of the fees charged, dropping to just under 30% when the account balance is $100,000. Even for

[1] Analysis conducted by Rice Warner, available on request, is on administration fees as a proportion of the total fees for all MySuper products in the *APRA MySuper Product Heatmap – Fees and Costs*
[2] In this graph the interquartile range (IQR) (that is, the 1st to 3rd quartile) is depicted by the box. The line in the middle of each box shows the median (that is, 2nd quartile) while the "X" represents the mean result. Each whisker reflects the points which sit at sit 1.5 times the IQR below and above the 1st and 3rd quartiles. Dots represent data points which fall outside these whisker ranges

members with $250,000 the administration fees charged for about one quarter of all MySuper funds is greater than 50%.

Therefore, a fund with higher administration fees and lower investment fees may appear to perform in terms of investment returns net of investment fees, but when total fees are included results could be significantly under the benchmark.

This difference in the administration fees charged can have a significant impact on retirement balances.

For a member with a current-day balance of $10,000, the difference in retirement balance for a member in a fund with a low investment fee and low administration fee, compared to a fund with the same investment fee and a high administration is $78,000 at retirement (equivalent to approximately 11% difference in retirement balance).

Importantly, this same research shows that administration fees vary widely between funds regardless of the investment fees charged, worsening the distortion and impact of excluding administration fees. Performance benchmarking against only investment fees may therefore provide members with a skewed impression of the net returns they are receiving on their superannuation.

Rest proposes the inclusion of administration fees because measuring performance net of total fees provides a more appropriate basis of comparison, by demonstrating delivery of outcomes to members at retirement.

We acknowledge that measurement including total fees has limitations, due to fixed dollar and percentage-based fee structures making it complex to aggregate on a whole membership basis. However, we note that APRA has previously determined sample balances for fee comparison purposes that could be appropriate in this context.

An alternative to the above approach would be consideration of a fund's administration fee in the event that a fund fails the annual performance benchmark review, assessed by APRA, prior to the consequential actions being required.

Modifications to enhance the efficacy of the performance benchmark

To ensure that the performance benchmark test reflects a balanced portfolio that exists in a fund that actively manages to a Strategic Asset Allocation (SAA) process, it is important that the benchmark reflects an appropriate comparable test.

The current proposed test has two major shortcomings:

The **first** is that it has an unacceptably high likelihood of that good performing funds could fail the test, while also resulting in poor performing funds in passing the test.

The **second** is that the test will encourage funds to change their investment strategy to be shorter term in focus, away from long term unlisted assets such as nation building infrastructure, investment in agriculture and in direct property in Australia, which have delivered strong returns and diversification to Australians who could not access directly themselves.

To this end, we encourage consideration of:

- Including appropriate benchmarking of unlisted assets
- Including a multiple tests approach
- Extending the investment horizon test to 10 years

Rest and our investment advisers have been conducting analysis of the proposed performance benchmark, and while we strongly believe in the value of an effective performance test, this analysis showed that in a number of cases **the *Your Future, Your Super* test approached a 50% likelihood of successfully identifying a "poor" fund as poor, and a similar likelihood of mistakenly identifying a "good" fund as poor**.

Appropriate benchmarking of unlisted assets

The proposed test benchmarks unlisted assets against a listed index, which is not a reasonable comparison. Unlisted assets are quite challenging to benchmark, as the performance of these asset classes may differ from a listed index equivalent by up to 15% p.a. over quite extended periods. Performance cycles can also be significantly longer; with differences in unlisted assets compared to listed assets in the same classes occurring over extended time frames.

Alternatives to the listed index would be:

- Australian and overseas private equity: Cambridge Associates indices
- Listed infrastructure: CPI+5% due to the limited availability of indexes
- Unlisted Australian Property: MCSI / Mercer Australian Wholesale Pooled Property Fund Index
- Unlisted International Property: NCREIF ODCE Index Hedged

Including a multiple tests approach

We consider that a well-designed collection of metrics will be more effective than a single metric. The 'single, simple' test is too simplistic to provide an effective measure of performance, given the serious consequences of not meeting the proposed test. The problem of legislating a single point-in-time test is:

- A very large proportion of the industry may "fail" the test at the same time in the event of a single adverse industry outcome (eg a sharp drop in the AUD value, or rise in interest rates)
- The test strongly discourages funds from adopting active risk management strategies **within** asset classes.

There is a range of solutions that could involve multiple investment performance, for example, a CPI+ objective, SAA peer group comparison, simplified reference portfolio and SAA benchmark portfolio. Fee comparisons could also be included. For consumers, this would still lead to a single result, but would provide a measure more reflective of the variation in investment approaches across superannuation.

Extending the investment horizon

Many superannuation funds establish SAA processes that look to a 10-year investment horizon. In fact, **the MySuper dashboard requires funds to set investment objectives on a 10-year timeframe**. Given the long-term nature of superannuation investment, and that funds are looking to preserve and build capital for members over a 40 to 50-year period, the longer period is more reflective of the strategies established by funds.

In addition, we have concerns about the 0.50% threshold for "failure" against the benchmark within the eight-year horizon. The combination of an eight-year horizon and 0.50% threshold works to make the test a very poor indicator of performance.

To explain: with a threshold of 0.50% on an eight-year horizon, even prudently managed funds will have an approximately 25% probability of failure against the benchmark once every eight years, due only to the vagaries of normal market movements. However, widening this threshold to 0.75% reduces this probability to around 15%. At the longer 10-year horizon, but retaining the 0.50% threshold, the probability reduces to 20%.

This clearly shows that not only would the test result in the wrong outcome, but that funds adopting a 10-year investment strategy would be more likely to fail the test than those adopting a shorter-term time frame.

Rest supports the intent of having a performance measure to protect members from underperforming funds, but without changes the outcomes will not achieve the Government's policy as well as fundamentally changing the way funds invest and working against the best financial interest of Australian superannuation investors and broader nation building opportunities.

Appendix 2 –Matters relating to the best financial interests duty

Rest supports measures to ensure that superannuation funds prudently and appropriately manage expenses to ensure that they are in the best financial interests of their members. In fact, we believe that consideration of the best interests of members as currently addressed in the SIS Act Section 52 obligations must include consideration of the best financial interests of members.

We are concerned that the new obligations as drafted, specifically the need to identify quantifiable financial benefit to members for every expense, regardless of amount (ie. that there is no materiality threshold), combined with the reversal of the evidential burden of proof on trustees, will create an administrative burden that will result in additional costs to funds as well as limit innovation.

Rest, like other superannuation funds, currently has processes that develop proposals and business cases around initiatives and expenses that involve executive and Board approvals, where appropriate. We are concerned that the new obligations will result in administrative processes to ensure that these artefacts can support sufficient evidentiary burden in an environment where the onus of proof is placed on the trustee. To be clear, it is the combination of the reversal of the onus of proof, plus no threshold, that we believe will place an excessively onerous burden on funds and trustees.

We seek consideration of a materiality threshold for expenditures subject to these requirements, with the understanding that APRA would be able to investigate any expenditure items, as is currently the case. Alternatively, we seek reconsideration of the approach reversing the evidentiary burden of proof.

In addition, we find the amendment to allow regulations to be made to specify that certain payments or investments, even when that payment may be seen to be in the best financial interests of the members to be prohibited, particularly concerning. We believe that this subverts the fiduciary duty responsibilities held by trustees and consider that there is risk that this may be used for political purposes in the future.

The responsibilities of trustees to act in the best interests of members is a long-established principle, and requires trustees to consider risk, benefit, environmental matters and the long-term interests of fund members. The imposition of an outright ban on certain payments or investments placed by a government of the day risks limiting the ability of a trustee to act on consideration of all these matters, and therefore carries a risk of unintended consequences.

We therefore seek further consultation on this element of the best financial interests duty draft, so that potential consequences can be considered.