**Executive Summary**

This submission provides Chant West’s feedback on the proposed ‘Your Future Your Super’ reforms as outlined in the Budget proposals and recently released Exposure Drafts.

We support the policy intent to address unintended multiple accounts and underperforming funds. But we believe that the proposed initiatives need further modifications to ensure they lead to better outcomes for members rather than creating new problems to fix.

We believe the proposed performance test, with the huge asymmetry between not meeting the benchmark and doing much better than it, will inevitably lead to poorer investment outcomes for members in many funds. Further, there is the risk that the operation of the performance test, in its current form, may trigger a disorderly stampede to the exits of some funds and further undermine public confidence in the system as a whole. We support the Exposure Draft’s insertion of APRA’s role in determining the formulas to use for the performance test and its discretion in determining whether a fund has passed the performance test, but the final wording of the Regulations will be important to ensure an appropriate level of discretion is provided.

We support the principle of account stapling but it needs to be accompanied by regular and effective engagement with members at key milestones, like starting a new job, otherwise it may lead to less engagement and many Australians remaining in ill-suited funds. And for account stapling to work, there must be an online service available through which employers can be instantly informed of an employee’s stapled fund. If this service is not available at 1 July 2021, the introduction of account stapling should be delayed.

**The performance test**

It is important for the integrity of the system – and for the protection of members – that chronically underperforming funds are identified and removed from the system. We support this objective. Our concern is not with the concept of an annual performance test but with how this single test will be used.

In the first year of failing the test, a fund will need to inform its members that it is an underperforming fund and refer them to the *YourSuper* comparison tool, where its underperformance will be highlighted. If it then underperforms for a second year, it will be barred from accepting any new members – and again, it will have to report that to its remaining members.

Failure in the first year alone will probably lead to a flight from the fund. Failure for a second year would most certainly do so. A sudden outflow of members and assets would be to the detriment of those members who remain, as investment strategy would need to change to focus on short-term liquidity rather than long-term performance.

*How will funds respond to this test?*

We need to consider how these proposals are likely to influence funds’ behaviour. If a fund fears that it is heading towards underperformance it may be tempted to take additional risks in a last-ditch attempt to avert it. This plan may not work and members will pay for it. Funds whose existing performance record is close to the benchmark may become totally risk-averse and adopt a ‘survival at all costs’ strategy, dumbing down their portfolios to ensure they can’t stray far from benchmark performance. By contrast, funds that already have a strong performance record are likely to use that buffer to continue with their successful investment approach. The gap between the best and the rest is likely to widen but we expect there will be investment strategy implications even for better-performing funds.

*Is this a good test?*

In our view, the performance test as proposed is far too blunt as the sole instrument used to weed out underperforming funds. The test is based on one performance metric over one time period. Further, the metric is based on performance compared with a benchmark portfolio that matches the fund’s strategic asset allocation at the asset class level. This approach removes any recognition of value that has been added through asset allocation, the key driver of value for members, and simply measures how well a fund has implemented its strategic asset allocation. All investment professionals know that implementation represents only a small portion of value generated from investments and most value is generated by asset allocation, which is not measured in the Treasury approach.

Indeed, it is difficult to come up with a better model if the goal is to have a single metric. The current APRA Heatmap uses a benchmark portfolio with the same level of growth assets (the Simple Reference Portfolio) that recognises some of the value added through asset allocation but it too has some comparison issues, such as the definition of growth assets. It also measures performance over different periods rather than over one single period.

*The core problem – asymmetric consequences*

Perhaps the biggest problem with this use of the performance test is that the consequences of bettering or failing the benchmark are so asymmetric. The penalties for failure (likely termination of the fund) far outweigh the benefits for success (possibly gaining some more members), so this regime will inevitably lead funds towards risk-averse behaviour that’s likely to reduce longer-term returns. It would discourage the diversification that has characterised the best MySuper products and their precursors for decades. And it would discourage innovation in seeking out new sources of return, because the risks of new ideas not paying off would far outweigh the rewards. New sources of return will be particularly important given the challenges that some traditional asset classes face in coming years (especially defensive assets). For all these reasons, we believe the proposed use of the performance test would be detrimental to the super system, and not in the best interests of members.

Further, the performance test doesn’t capture the success (or otherwise) of super funds in delivering actual outcomes for members, in terms of dollars in accounts, which is impacted by more than just performance. APRA’s recently introduced outcomes test, which was endorsed in the Productivity Commission report, is a very important development that tries to address this issue. The annual outcomes assessment, as it is now called, includes a range of evaluations as part of the benchmarking, not simply one metric upon which the whole assessment is based. We believe this multi-factor approach is a much more appropriate way to assess super funds. And we are already seeing some positive outcomes of funds improving or seeking to wind up or partner with another fund.

*A better process*

Rather than a super fund not meeting the singular performance metric once and having to nudge members to consider other funds, we believe that such funds should be required to engage in a rigorous review process with APRA to determine their future. Funds would be required to demonstrate to APRA why they are able to provide improved member outcomes in the future. Part of this would be explaining reasons for their underperformance over the statutory period which may include improved performance in the months following the assessment (illustrating the end-point dependency of the assessment date), material changes to team structure or to the investment strategy/asset allocation during the assessment period, and significant market corrections or shocks that particularly impacted on their investment portfolio and are likely to turn around.

In its assessment, APRA should have the flexibility to consider other matters beyond the statutory performance metric including performance over other periods, the quality and value of insurance and the provision of member services and advice, and the success of these initiatives in driving better outcomes for members.

We believe that such a detailed assessment should be conducted before the regulator ‘pulls the trigger’ and a fund is obligated to nudge members to look elsewhere. If APRA can engage constructively with funds that are struggling it will be better placed to make an informed judgement on whether they should be closed to new members – or, indeed, closed completely. If that’s the case, APRA could help facilitate a Successor Fund Transfer to ensure a more orderly exit of members. This would be preferable to funds being publicly discredited, followed by an abrupt exodus of members that would only serve to erode confidence in the system.

We support the Exposure Draft’s insertion of APRA’s role in determining the formulas to use for the performance test and its discretion in determining whether a fund has passed the performance test, but the final wording of the Regulations will be important to ensure an appropriate level of discretion is provided.

*Technical issues to be addressed with the proposed performance test*

Any reform proposals inevitably give rise to complications in their application, and this time is no different. Just briefly, here are some more obvious issues that would need to be resolved in how the performance test would operate:

* How the test would be applied to lifecycle products where some cohorts might clear the hurdle, but others fall short. The fund as a whole would need to pass or fail the test, so the variances from benchmark for different cohorts would have to be asset-weighted, member-weighted or some other method. We expect a member-weighted assessment would be more appropriate so that the outcomes of higher balance older members do not dominate the assessment.
* Fund performance will be assessed against reference portfolios based on each fund’s strategic asset allocation (SAA). The problem is that the SAAs published by funds are quite different in nature. Some funds have long-term SAAs that rarely if ever change, while others have more fluid SAAs that are adjusted according to their outlook for asset sectors over the next year or two. So the asset allocation that determines the reference portfolio, the key measure of success, represents different things to different funds. This will mean some funds will be advantaged and others disadvantaged by the way they disclose their SAAs.
* The proposed performance test is measured after investment fees and tax, but should it be after administration fees as well? While it may seem natural to measure performance net of all fees, there are some problems with this approach. One is that administration fees generally include a dollar-based element so any comparison will depend on the account balance assumed. While a common account balance could be used (e.g. $50,000) which could work for MySuper products, this balance may not be appropriate for some retail choice products that target higher balances (which will be included in 2022).

Including administration fees would introduce another complication in that the benchmark portfolio performance would need to be adjusted for some assumed level of administration fees and the impact of related tax deductions. Further, the most relevant administration fee to include in the analysis would be the current fee, rather than the fees charged historically which will be reflected in ‘net of all fees’ returns. For this reason, we believe it is best to consider performance net of investment fees and tax only, and to consider administration fees separately. This has the added advantage of clarifying whether a fund’s underperformance net of all fees is due to investment or fee issues.

* The proposed 8-year measurement period seems to be fairly arbitrary. We’ve never come across any funds that use this time period for measurement. The choice of this period by the Productivity Commission may have something to do with its view that fund-level data improved from 2011, allowing the full range of funds to be included in the analysis. As more data becomes available, we believe a 10-year period (the same period that most funds now use for their performance measurement) would a more appropriate timeframe to represent the long term.

*What about a test on fees?*

ASFA’s proposal suggested that fees should come into consideration as well as performance. This is something we would support, although we believe ASFA’s proposed fee threshold is too generous and that passing the fees test should not provide exemption from the investment performance test. We believe there should be a separate test on fees that funds must also meet.

There is a case for having the fees test relate to administration fees only, because investment fees are captured anyway in the net performance data. It would seem wrong to penalise funds that have high investment fees if – as is often the case in MySuper products – those higher investment fees relate to unlisted and alternative assets that help to drive higher net returns. If only administration fees are tested then of course there is the possibility of fee-shifting to ‘game’ the system, which would need to be monitored. The administration fee benchmark for MySuper could be set at say 0.50 or 60% for a $50,000 balance as APRA has done in its MySuper Heatmap (APRA starts to highlight administration fees as high from about 0.50%).

**Multiple accounts – a consequence of the current default system**

The current system where members are allocated to funds by default when they start a new job – unless they exercise choice of fund – has resulted in millions of unintended multiple accounts.

Even after a concerted effort to encourage members to consolidate accounts, 36% – or about 6 million people – still have more than one account and 5% have four or more. We expect these numbers will have improved somewhat with the introduction of Protecting Your Super (PYS) and the account consolidation efforts of funds themselves, but the problem remains. While some of those multiple accounts may be justified, perhaps to preserve insurance cover, the vast majority are not. They represent one of the greatest inefficiencies of the system and account for a huge amount in wasted fees.

The stapling approach, described in the ‘Your super follows you’ Budget initiative, presents an opportunity to address this issue by stopping the ongoing creation of even more multiple accounts. This approach was a key recommendation of the Productivity Commission report and it seems to be the most practical solution to the problem. Conceptually it makes sense for a member’s existing fund account to follow them from job to job, but that assumes (a) that the fund was suitable for them in their old job and (b) that it will continue to be suitable for them in their new job. We need to make sure, once again, that this initiative is implemented in a way that addresses the current problems and doesn’t create new problems.

Under account stapling, the only time that a default fund is relevant is when someone starts their first job. When they start subsequent jobs, their current fund will become the default. Staying put in an existing fund will be easy for employees, and the proposals outline how the ATO will make that a simple option for employers too.

Throughout its proposals Treasury emphasises the need to stimulate competition, but there’s a danger that the implementation of stapling will work in the opposite direction. Many young people will start out in, say, retail or hospitality on a part-time or casual basis, and be enrolled in the default funds for those occupations – typically Rest and Hostplus. When those young people then move into longer-term careers in other occupations, the stapling model would have them stay in those original funds for the rest of their working lives unless they choose otherwise.

However, the insurance available in these funds may not be appropriate for someone moving into higher risk occupations such as construction or lower risk occupations like teaching or office work. Those members may be better in a fund that’s focused on those occupations, with appropriate insurance for that group, or in a corporate plan that has secured tailored insurance arrangements that provides appropriate levels of default cover for the occupation, at relatively low cost. This arrangement of defaulting once for new entrants to the system is not ideal, but neither is a ‘Best in Show’ model where new members joining the system are allocated randomly between top-performing funds if they do not choose.

Another problem scenario is for a current member of a corporate plan whose employer may have negotiated significant discounts on fees and/or insurance and for whom their plan represents excellent value. On leaving that employer the member will remain in the same overall fund, but they will transition from the employer plan to the generic MySuper product where they will generally pay higher fees and premiums. Again, unless the member makes an active choice when they start their new job, they may be left in an inappropriate product by default. It’s also hard to see how new members would access these corporate plans in the future as they would need to actively choose. This may lead to the phasing out of corporate plans that often represent very good value to members.

*Can we make choice work?*

Treasury’s model is aimed at empowering members by providing easy access to comparative data about funds through the *YourSuper* tool and so shifting the system towards individual choice, which is a reasonable goal. The success of the stapling model relies on members, at key times over their career, considering whether their current fund is appropriate for their circumstances. But is this achievable? Is it realistic to think a meaningful number of members will be engaged enough to choose their super fund? And if so, are they likely to make good choices? Indeed, stapling has the potential to actually reduce engagement as nothing needs to be done in relation to super when someone changes jobs.

For account stapling to work, there must be an online service available through which employers can be instantly informed of an employee’s stapled fund. This seemed to be the intent from the Treasury proposal at the time of the budget but the Exposure Draft and Explanatory Materials seem to describe a manual process whereby the employer requests and the Commissioner provides notification of the employee’s stapled account. It will be imperative to have this notification occur online and instantly from the commencement of the account stapling regime at 1 July 2021. If an online service is not available at 1 July 2021, the introduction of account stapling should be delayed.

Once this online notification system is introduced for employers, it is also important for employees to be provided with the opportunity to review their superannuation arrangements regularly and at appropriate times, especially when they are changing jobs. Indeed, Recommendation 1 from the Productivity Commission’s final report was:

‘The Australian Government and the ATO should continue work towards establishing a centralised online service for members, employers and the Government that builds on the existing functionality of myGov and Single Touch Payroll. The service should:

* allow members to register online their choice to open, close or consolidate accounts when they’re submitting their Tax File Number on starting a new job
* facilitate the carryover of existing member accounts when members change jobs
* collect information about member choices (including on whether they are electing to open a MySuper account) for the Government’

This solution would ensure that whenever any employee started a new job, they would interact with the centralised online service and would be presented with their current fund and asked whether they wanted to retain that fund or choose a different fund. While the concept of a default fund would no longer exist, new employees could be presented with their employer’s ‘preferred’ fund as an option. This ‘preferred’ fund could be an industry fund, corporate fund, public sector fund or a corporate plan that has been negotiated for that particular employer. Product information could be provided for the member’s current fund and the ‘preferred’ fund as part of the centralised online service or as part of the *YourSuper* comparison tool.

For this approach to succeed there would need to be universal participation in the online service from all employees and employers. This should be possible, given the need for employee, employer and ATO to interact at the commencement of employment to provide the employee’s Tax File Number.

While the Treasury paper discusses the *YourSuper* comparison tool and the employer portal that allows them to identify an employee’s current default fund, it has ignored the Productivity Commission’s recommended use of such a service as part of onboarding employees alongside the TFN declaration, which in our view is critical for this model to succeed.

This centralised online service could also be incorporated into the tax return submission process on the myGov website to ensure that every person is presented with their current fund at least once a year. It may also be helpful to nudge employees to review their super fund at some key milestones, especially if they have retained their original default fund from their teenage years. A key milestone may be their 25th birthday, by which time they are more likely to have finished training and settled on a particular industry for their future career (at least for a time) and it is also when members are eligible for default insurance.

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