Chant West

Submission to YFYS Consultation

May 2021

About Chant West & introduction

Chant West is a leading superannuation research firm established in 1997. It conducts research on most of the leading superannuation and pension funds, asset consultants and implemented consultants in Australia. Its research is purchased by most of Australia's leading superannuation suppliers and its comparison tools are widely used by consumers, funds and financial advisers. Chant West was purchased in June 2020 by Zenith Investment Partners.

This submission provides Chant West's feedback on the draft 'Your Future Your Super' regulations that were issued on 28 April 2021. Our comments relate to the proposed performance test and account stapling.

Performance test – introduction

In our previous submission we raised a number of issues with the proposed performance test. We were concerned, and remain so, about the use of one metric over a single period to determine whether a fund passes or fails, and therefore whether it can continue to operate in its current form. We believe the asymmetry of consequences of the proposed performance test – between not meeting the benchmark and doing much better than it – will inevitably lead to poorer investment outcomes for members in some funds, as the focus shifts in those funds from long-term performance to passing the test (which is the only rational approach for a fund that is in potential danger of failing the test). Our submission proposed a model where a fund that fails the performance test enters a review process with APRA to identify any extenuating circumstances that may warrant withholding the consequences of failing the test, eg. where a fund made changes five years ago to an underperforming investment strategy that has since resulted in strong performance, but the test is still failed over the seven-year period.

However, both APRA and Treasury have clearly expressed the need for a 'bright line test', i.e. a test that results in a pass or fail without any ability for review. Therefore, the task must now be to ensure that the performance test is best suited to its purpose.

In Treasury's draft documentation issued in November 2020, the performance test was to be based on net investment returns, i.e. net of investment fees and tax, but before the deduction of administration fees. We supported this approach as it measured investment performance and was not obscured by non-investment issues such as administration fees. However, in recognition that the level of administration fees has an important impact on member outcomes and must be included in the assessment in some way, we proposed a separate 'administration fee' test, based on current administration fees and costs. This approach is consistent with the structure of APRA's MySuper Product Heatmap which considers past performance and fees (for the last 12 months) separately. The advantage of this approach is that it allows the two main influences of member outcomes – investment performance and administration fees deducted – to be considered separately, better highlighting whether any issues relate to performance or the level of administration fees.

However, Treasury has become increasingly clearer in articulating that the performance test must be a singular test. And it appears that this has resulted in the proposed performance test in the Exposure Draft Regulations that includes both investment performance and administration fees (on a $50,000 balance). Indeed, if there can only be one metric then it should include administration fees and costs as these fees clearly impact member outcomes. Nevertheless, we still believe it is preferable to have two separate tests – one based on net investment returns and the other on administration fees and costs – both of which need to be met to pass the 'performance test'.

Performance test – administration fees and costs

If administration fees and costs are to be included in the single performance test, the question we need to ask is 'Are the administration fees and costs used in the analysis disclosed on a consistent basis?'. The data for administration fees and costs will be sourced from APRA's quarterly MySuper data. Is this data presented consistently across all funds? If not, some funds will be advantaged or disadvantaged purely because of their disclosure. Indeed, it is likely that funds with disclosure that has not been best practice will be advantaged – this would be far from ideal.

Differences in the disclosure of administration fees & costs (gross and net of tax)

The disclosure of administration fees and costs in Product Disclosure Statements has been problematic for many years. One key difference between funds is that some pass on to members the benefit of tax deductions relating to administration fees and costs, either as lower tax on contributions or the deduction of a lower administration fee than disclosed, but other funds don't do that and transfer the tax deduction to the administration reserve to cover some administration expenses (meaning they can charge a lower fee).

The new RG97 regime, which must be adopted by 30 September 2022 at the latest, should finally deal with this issue through the requirement for funds to disclose the costs paid from reserves as part of administration fees and costs. It will mean that funds that transfer this tax benefit to the administration reserve will soon need to disclose these amounts as part of administration fees and costs. Initially, we had thought that this would be a problem area in the use of APRA's MySuper data for administration fees and costs for the performance test, as funds have disclosed their administration fees and costs to APRA on different bases. However, the proposed formula for the 'relevant administration fees and expenses' (RAFE) has incorporated both 'representative member administration fees and costs' and 'representative member administration-related tax expense/benefit', as disclosed in APRA's MySuper data tables. For this reason, we believe that **this fee disclosure issue has been adequately dealt with in the construction of the RAFE**.

Differences in the disclosure of insurance premiums that impact administration fees & costs

There is a similar problem with insurance premiums. While most funds pass on to members the benefit of the tax deductions relating to their insurance premiums, some funds transfer these tax deductions into the administration reserve instead – this enables them to charge their members lower administration fees. Since the origin of the tax deduction (from insurance premiums) is not related to the account where it is credited (the administration reserve), it is not possible to use a similar 'tax rebate' adjustment to account for this issue in the APRA data. This issue will also be resolved with the requirement in the new RG97 regime for funds to disclose 'costs paid from reserves'. But this issue is present in all the historical APRA MySuper fee data for several funds and impacts both the RAFE for these funds as well as the net return. The use of this approach has allowed some funds to disclose lower administration fees and costs as they can pay some of their administration expenses from the tax deductions relating to insurance premiums.

How significant is this issue? Table 1 shows the impact on administration fees for the funds (de-identified) that we believe have adopted this practice, based on their PDS disclosure and email correspondence with those funds. It shows the impact as a percentage of assets in both 2015 and 2020.

Table 1 shows that 13 funds retained the benefit of the tax deduction at either June 2015 or June 2020, with the median impact on administration fees of 7 basis points in 2020 and 14 basis points in 2015 (the impact for one fund was much higher). The reason why the median impact on fees was lower in 2020, compared with 2015, is a combination of higher assets at 2020 and lower total insurance premiums in 2020 due to account consolidation and the removal of insurance for some members due to PYS and PMIF.

Table 1: Impact on administration fees of retaining tax deduction on premiums (% pa)

Fund	June 2020	June 2015
Fund 1	0.03	Nil
Fund 2	0.07	Nil
Fund 3	0.08	Nil
Fund 4	0.07	0.20
Fund 5	0.35	0.30
Fund 6	0.05	Nil
Fund 7	0.08	0.15
Fund 8	0.04	0.04
Fund 9	0.04	Nil
Fund 10	Nil	0.18
Fund 11	Nil	0.11
Fund 12	Nil	0.09
Fund 13	Nil	0.04
Median (of funds that retain tax deduction)	**0.07**	**0.14**

The administration fees and costs for these funds will be understated by the amounts shown above, compared with other funds that pass on the tax deduction to members. Significantly, the benefit is greater in the earlier years of MySuper than it is currently (this has implications for the calculation of RAFE that will be discussed further below). **This disclosure practice will make it easier for these funds to pass the performance test than for other funds, and it will also artificially reduce the benchmark RAFE in each quarter.**

Accuracy of administration fees & costs in APRA data

Another area to consider is the accuracy of the administration fees and costs that funds have disclosed to APRA which are then published in APRA's MySuper quarterly reporting. We have analysed the administration fee data in detail, and we believe that most of the data seems reasonable based on the fee disclosure of funds at each quarter since 2014. However, there are a number of funds where there are clear problems.

Table 2 describes funds with missing administration fee data in the quarterly APRA fee data (again, this data has been de-identified). Significantly, most of the problems relate to the first few years of MySuper, but the use of historical administration fees for each quarter from 2014 will mean that the administration fees for these funds, and their contribution to the benchmark RAFE, will be understated. **Combined with the larger impact of the tax deduction on insurance premiums in earlier years of MySuper, this feature starts to push us in the direction of using a shorter period for the determination of the administration fees and costs to include in the RAFE and benchmark RAFE.** This will be further discussed in the next section.

Table 2: Administration fees & costs missing from APRA data (% pa)

Fund	Description
Fund A	The $-based administration fee was not disclosed from Jan 14 to Mar 20
Fund B	The %-based administration fee was not disclosed from Jan 14 to Dec 16
Fund C	The %-based administration fee was not disclosed from Jan 14 to Jun 15
Fund D	No admin fees were disclosed for any quarterly reporting period
Fund E	The %-based administration fee was not disclosed from Jan 14 to Sep 15
Fund F	The %-based administration fee was not disclosed from Jan 14 to Jun 15
Fund G	Some of the %-based administration fee was not disclosed from Jan 14 to Jun 16
Fund H	The %-based administration fee was not disclosed from Jan 14 to Sep 17
Fund I	The %-based administration fee was not disclosed from Jan 14 to Sep 16
Fund J	The %-based administration fee was not disclosed from Jan 14 to Sep 16
Fund K	The %-based administration fee was not disclosed from Jun 15 to Jun 20
Fund L	Some of the $-based administration fee was not disclosed from Jan 14 to Sep 15
Fund M	Some of the $-based administration fee was not disclosed from Jan 14 to Mar 15

Fee changes in recent years

The final point to consider on administration fees is that the proposed treatment of RAFE will consider the administration fees and costs charged over each of the last 7 years. However, historical fees are not what is most relevant to current members of the fund, many of whom have only joined the fund in the last 1-3 years. What is relevant to current members is the current level of administration fees and costs. The purpose of the performance test should be to assess the quality of member outcomes for current members. In terms of performance, the best that we can do is to look at past performance. But in terms of administration fees, we have more information than past administration fees that are no longer relevant to members – we have the current level of fees that will be what impacts retirement outcomes for members. For this reason, we believe current (or at least, recent) fees should be used. And what makes this proposal more compelling is the number of changes in administration fees over the last few years.

Table 3 shows the number of MySuper products that have changed fees since June 2017, roughly halfway through the period under consideration. While many of the funds that have reduced fees are retail funds, 14 of the 32 funds that have reduced fees are profit-for-member funds. On the other hand, there are a number of funds that have recently increased administration fees and that will be assessed on lower historical fees than what is currently charged.

Table 3: MySuper products that changed administration fees since June 2017

	Number of MySuper products
Increased fees*	24
Decreased fees*	32

* Based on an account balance of $50,000.

One driver for many of the increases in administration fees in recent years has been the introduction of Protecting Your Super (PYS) on 1 July 2019, which removed a large number of inactive accounts for some funds. This meant that some funds had to increase their fees as many members, who were inactive and quite cheap to administer, had been removed from the fund. For this reason, the post-PYS (from 1 July 2019) administration fees and costs are a better measure of ongoing administration fees and costs.

An important driver in the decrease in fees was the need for retail funds to reduce administration fees and costs to a level that was acceptable in the MySuper Product Heatmap. All major retail providers have now done so, many reducing fees in the order of 20-30 basis points (most of them in 2020). If we are to base our assessment on administration fees and costs over the whole MySuper period, these funds will be assessed on higher administration fees and costs than are currently charged, which are no longer relevant to any members.

A better way to apply administration fees & costs

We believe that a better approach to including administration fees and costs in the performance test would be to use either current or 'recent' administration fees and costs. While current fees and costs would be most effective in indicating ongoing member outcomes in these products, using a current fee level (eg. at 30 June 2021), may open the door for some funds to 'game' the system by shifting some of their administration fees into their investment fees just before 30 June to ensure they meet the performance test outcomes. For this reason, **we believe that the performance test should use the administration fees and costs for either the last 2 years or last 12 months**. Indeed, the use of administration fees and costs for the last 2 years would accord with the introduction of Protecting Your Super and the resetting of administration fee levels that followed in a number of funds.

How would the fees for the last two years be incorporated into the test? The easiest way would be to **base the performance test on the net investment return for the 7 or 8 year period and then deduct the RAFE for the 2 years leading up to the assessment date**.

The use of administration fees for the last 2 years (or last 12 months) would also avoid most of the problems with missing fee data for the 13 funds listed above. Further, it would mean that once the tax deduction on insurance premium issue has been resolved with the new RG97 regime, this distortion will quickly move out of the numbers, rather than remaining in the data for a further 8 years. It will also mean that the largest impacts from this insurance premium issue (in the earlier years of MySuper) will not impact the performance test.

Corporate discounts on administration fees

One final issue on administration fees is the provision of corporate discounts in some MySuper products. There are two sorts of corporate discounts of administration fees provided in MySuper products – discounts in 'Large Employer' MySuper products (when compared with the generic MySuper product offered by the same provider) and discounts for employers in the standard MySuper based on employer size. These discounts are generally provided in retail funds but also through the corporate divisions of some industry funds.

The 'Large Employer' MySuper products will be assessed as separate MySuper products. They typically have lower administration fees than the corresponding generic MySuper products and their inclusion in the data set will have the effect of reducing the benchmark RAFE (we estimate by about 2-3 basis points). Since these products are only available to employees of a particular large employer and not the general population, it is probably best to exclude these funds from the calculation of the benchmark RAFE, even though the difference is relatively small.

The discounts for employers in the standard MySuper will not be taken into account in the current performance test as the test will be based on undiscounted pricing. While this is consistent with how the

APRA MySuper Product Heatmap is presented, it will mean that products will be assessed on the standard 'rack rate' administration fees and costs which, in some funds, do not apply to most members. Indeed, if a MySuper product narrowly misses the performance benchmark, it is likely that the outcomes for many fund members with discounted pricing will have actually met the benchmark. While it may be difficult to account for this in the assessment, as fees charged to members will vary from full administration fees to very low administration fees across hundreds/thousands of employers, it will make the communication to members of a failure to meet the benchmark quite problematic. Indeed, for some of these members it would be factually incorrect to say that their fund failed the test when, in their case, the test was passed. This issue may need further consideration by APRA and Treasury. One solution could be that members of plans who had sufficient fee discounts to pass the test would not need to be notified that their fund failed the performance test, as in their case it did not.

The performance test – other comments

We support the requirement in 9AB.8 (a) (b) that a product needs to have five years of operation for the performance test to be applied – any shorter and the performance will be impacted too much by short-term effects that may not be reflective of the quality of member outcomes provided.

We also note that the Exposure Draft allows APRA to combine performance for similar MySuper or trustee-directed investment options. This is necessary for funds that introduce a new MySuper investment structure or investment option, as it shouldn't then take a further five years for the product to be assessed. It is also required for fund mergers as it will need to be determined how to combine performance in these circumstances. This is a problematic area and APRA will need to ensure that its approach does not discourage mergers (or indeed penalise recent mergers) by simply applying some sort of average across the merging funds – one fund may have merged with another due to poor performance and the receiving fund should not be penalised for this.

We also support the exclusion of single sector investment options (only relevant in choice) from the performance test as these options are typically used in combination with other investment options as part of a bespoke investment strategy.

As we discussed in our previous submission, since the test is based on performance relative to a benchmark portfolio that matches the fund's strategic asset allocation at the asset class level, it removes any recognition of value that has been added through asset allocation, the key driver of value for members. It simply measures how well a fund has implemented its strategic asset allocation and how successful it has been with any dynamic asset allocation tilts. Since the release of the draft legislation in November, some proposals have tried to account for asset allocation. A particularly promising solution from the Conexus Institute was that the benchmark portfolio for the performance test should match the volatility of the fund's portfolio rather than its asset allocation – this has the advantage of recognising the diversification benefits of a portfolio. A potential problem with this approach is that the frequency of unlisted asset valuations may result in an understatement of volatility, even though this volatility is what is experiences by members. While this could be addressed by using the volatility of quarterly returns, rather than monthly, it may then have too few data points to be an effective measure. We believe the proposal from the Conexus Institute should be investigated further.

Indeed, there is a further problem with the current performance test's use of a reference portfolio based on each fund's strategic asset allocation (SAA). Unfortunately, the SAAs published by funds are quite different in nature. Some funds disclose 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 have defined their SAAs over the last 7 or 8 years – this is not ideal.

Stapling of member accounts

The current system of defaulting new employees to the employer's default fund has resulted in millions of unintended multiple accounts. While Protecting Your Super has dealt with this to some extent, it does make sense to stop the creation of new unintended multiple accounts through an approach such as stapling, even though there is a very real danger of members remaining in funds that are not suited to them based on industry and insurance cover.

How stapling should work for employees

The success of stapling relies on members, at key times over their career, considering whether their current fund is appropriate for their circumstances. In our view, it is critical for employees to be provided with the opportunity to review their superannuation arrangements regularly and at appropriate times, especially when they are changing jobs. Ideally, whenever any employee starts a new job, they would interact with an online ATO service to provide their Tax File Number (TFN) and would be presented with their current fund and asked whether they want 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. The provision of a 'preferred' fund would not be compulsory for an employer but would highlight, where relevant, when there is a fund that has been tailored to their industry or employer, particularly in relation to insurance.

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 TFN. The ATO could continue to prompt taxpayers to review their super fund at tax time each year through MyGov.

How stapling should work for employers

Account stapling also must work for employers and not add an undue burden when adding new employees. From the commencement of account stapling, there must be an online ATO service that securely allows employers to load up new employees (in bulk) and to receive a file with the stapled funds of all those employees (in bulk) - preferably within a matter of minutes or hours, but not days. Any solution that requires the request of individual employee details from the ATO, one-by-one, and then individual notification from the ATO of each employee's stapled fund, will add a huge burden to large employers and will reduce efficiency and increase costs.

It will be imperative to have an online ATO service that provides bulk upload and notification of stapled funds from the commencement of account stapling on 1 July 2021. If a secure online service is not available by 1 July 2021, the introduction of account stapling should be delayed.

Disclaimer: Zenith CW Pty Ltd ABN 20 639 121 403 (Chant West), Authorised Representative of Zenith Investment Partners Pty Ltd ABN 27 103 132 672, AFSL 226872 under AFS Representative Number 1280401, 2021. Our services may only be used by persons who have entered into a licence agreement with us, and use is subject to the terms of that licence agreement. Products, reports, ratings (Information) are based on data which may be sourced from a third party and may not contain all the information required to evaluate the nominated product providers, you are responsible for obtaining further information as required. To the extent that any Information provided is advice, it is General Advice (s766B Corporations Act). Chant West has not taken into account the objectives, financial situation or needs of any specific person who may access or use the Information provided. It is not a specific recommendation to purchase, sell or hold any product(s) and is subject to change at any time without prior notice. Individuals should consider the appropriateness of any advice in light of their own objectives, financial situations or needs and should obtain a copy of and consider any relevant PDS or offer document before making any decision. Information is provided in good faith and is believed to be accurate, however, no representation, warranty or undertaking is provided in relation to the accuracy or completeness of the Information. Information provided is subject to copyright and may not be reproduced, modified or distributed without the consent of the copyright owner. Except for any liability which cannot be excluded, Chant West does not accept any liability whether direct or indirect, arising from use of the Information. Past performance is not an indication of future performance. Full details regarding Chant West's research methodology and processes are available at www.chantwest.com.au. Chant West's Financial Services Guide is available at www.chantwest.com.au/financial-services-guide.