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The Treasury
Canberra ACT

25 May 2021

Subject: **Your Future Your Super Regulations and associated measures, 2021**

Dear Sir/Madam

Thank you for the opportunity to respond to the exposure draft of the *Treasury Laws Amendment (Your Future Your Super) Regulations 2021*.

Who is Mercer?

Mercer is one of the world's leading firms for superannuation, investments, health and human resources consulting and products. Across the Pacific, leading organisations look to Mercer for global insights, thought leadership and product innovation to help transform and grow their businesses. Supported by our global team of 22,000, we help our clients challenge conventional thinking to create solutions that drive business results and make a difference in the lives of millions of people every day.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $150 billion in funds under administration locally and provide services to over 2.4 million superannuation members and 15,000 private clients, including the Mercer Super Trust, which has around 220 participating employers, around 190,000 members and more than $24 billion in assets under management.

Introduction

As we have noted in our earlier submissions, Mercer supports the concepts of

- One superannuation account for life, unless the individual chooses otherwise
- The gradual removal from the industry of underperforming funds thereby improving the long term financial outcomes for members
- The development of a comprehensive consumer portal to enable individuals to compare superannuation funds and thereby encourage competition and better member outcomes.

However we believe that the proposed Bill and Regulations, as currently drafted, will lead to outcomes and behaviour that will disadvantage many members and lead to reduced retirement benefits and, in the longer term, higher Age Pension costs.

We make several recommendations within this submission to overcome the most significant consequences for members. The key recommendations are:

- Require an audit of all data reported to APRA to ensure it is fit for purpose
- Adopt actual asset allocations to ensure greater consistency and accuracy of the performance test
- Use actual fees paid by members and not historic 'rack rates' which are not representative of member experience

In addition, we recommend delaying the commencement date for Your Future Your Super to 1 July 2022 which will give sufficient time to incorporate the necessary adjustments and developments to ensure the successful implementation of the new legislation.

Commencement date

The Draft Regulations indicate that the provisions will commence the day after the relevant instrument has been registered. Similarly the Bill indicates that Schedule 1 and most of Schedule 2 will commence the day after the Act receives Royal Assent.

This uncertainty needs to be removed. In particular, Schedule 1 and the associated regulations dealing with single default accounts affect every employer in the country as they require changes to the on-boarding process for every new employee. All employers, whether large or small, need to plan for this change with the preparation of documents, processes and appropriate training of their staff. In addition, employers who support a particular superannuation arrangement for their employees will need to understand the extent to which they can promote this arrangement without breaching the financial advice or hawking provisions. The ATO will also need to develop a new Choice form.

Therefore Mercer recommends that the commencement date for Your Future Your Super should be delayed until 1 July 2022.

A commencement date of 1 January 2022 could be considered but it needs to be recognised that this would place the change in the middle of the holiday period when some employers are recruiting hundreds, if not thousands, of casual staff and many staff are on leave. A change in the on-boarding process during this period is likely to lead to many errors. In our experience, a commencement date prior to 1 January 2022 is not feasible.

A further advantage of the 1 July 2022 commencement date is that the ATO's digital software would then be available which is expected to simplify significantly the on-boarding process and thereby reduce costs for employers.

A delayed commencement date would also have the advantage of enabling the data integrity issue (see below) to be resolved prior to the implementation of the performance test.

Addressing Underperformance in Superannuation Regulations 2021

Data integrity

The proposed Regulation 9AB.3 notes that the lookback period will be 8 financial years unless subparagraph (a)(i) applies. This means that the performance assessment will be relying on data reported to APRA in respect of the relevant products since 1 July 2014.

However, APRA has previously recognised that the data provided to them, particularly in the early years of MySuper, has significant limitations and inconsistencies between different products. In other cases, the APRA instructions provides trustees with options in respect of reporting their strategic asset allocation. This leads to

inconsistency between products and interpretations by trustees or staff filling in the forms. In other cases, the reported data was simply incorrect. Hence the current data is not suitable for use in the performance test and will lead to incorrect statements being made to members. It is also worth noting that APRA is currently undergoing a Superannuation Data Transformation project to address these issues.

Indeed, in its 2019 report on the superannuation industry, the Productivity Commission noted on page 617: "APRA should also address glaring deficiencies in its existing data collection, tackle inconsistencies and misreporting by funds head-on".

Chant West's submission in respect of the draft regulations also highlights the inconsistencies in the data and the consequential advantages that would apply in respect of some products.

Therefore Mercer recommends that APRA issues clarifying instructions as to the basis on which data is to be determined, and that each fund must resubmit audited performance test data to APRA in respect of the relevant periods for the relevant products on that basis, where the newly reported data is also supported by documentation.

Asset allocation

The formulas expressed in Part 9AB of the proposed regulations to calculate the benchmark return for each product uses the product's benchmark strategic asset allocation (or $SAA_{a,t-1}$ or $SAA_{a,j,t-1}$) in relation to each quarter, as reported to APRA. In effect, this is the asset allocation published in the product's PDS.

The use of this approach has two material issues:

- It can produce a situation where two products, with identical administration and investment fees and which produce the same investment return with identical risk, can have different results from the performance test with one passing and the other failing. In effect, this means the test is based on each product's PDS (or brochure) and not the outcomes received by their members. Such an outcome would raise serious questions about the credibility of the test.
- It will encourage trustees to "game" the system by publishing and reporting a different asset allocation from that which they may intend to pursue over shorter periods, say the next 2-3 years. For example, it will encourage trustees to reduce their strategic asset allocation to certain higher risk asset classes thereby reducing the likely benchmark return. They may then tilt their portfolio towards these higher risk assets that normally provide higher returns, and so improve their probability of passing the test. Such an outcome is not in the interests of improved transparency to members or the introduction of a valid performance test.

It could be argued that the Corporations Act will prevent trustees from deliberately misreporting their intended asset allocation. However there will always be differences between the strategic and actual asset allocations as trustees and their investment advisers respond to changing economic and market conditions, and for some asset classes (eg unlisted investments) it takes time to build towards the longer term SAA.

Therefore Mercer recommends the use of actual asset allocation which would represent a fairer and more accurate performance test, avoid undesirable outcomes and ensure ongoing benefits to members of the legislation.

This approach will improve the accuracy of the information provided to members and remove the option to "game" the performance test. In addition, if the test is to have any real efficacy over the longer term, such a change is necessary.

It is also likely to lead to better outcomes for members as trustees will not be encouraged to limit their decisions to their published strategic asset allocation as economic or market conditions change.

Administration fees

The proposed performance test has introduced an additional component, namely the relevant administration fees and expenses (or RAFE) for each quarter and, in effect, compares this with the benchmark RAFE (or BRAFE) for that quarter. The RAFE for each product will be the figure reported to APRA for each quarter.

The proposed test uses the RAFEs for each quarter within the lookback period, namely 7 or 8 years in most cases. However these historical fees are no longer relevant as many MySuper products have changed their administration fees significantly during this period. For example, the Chant West submission shows that 24 MySuper products have increased fees since June 2015 while 32 products have decreased fees for an account balance of $50,000. That is, the use of historic fees is misleading as it does not represent the current fees paid by members or the fees likely to be paid in the near future.

The adoption of current fees must also be consistent with the new RG97 regime which resolves some of the historic reporting issues and consistencies, as well as clarifying some existing uncertainties.

Therefore Mercer recommends that current and not historical RAFEs be used in the performance test.

It should also be recognised that many employees of major employers who are members of a standard MySuper product do not pay the undiscounted or "rack rate" fee used in the APRA heat maps. That is, these employers have negotiated a discount for their employees.

This reality needs to be taken into account in the performance test. Otherwise, it is likely that a MySuper product could 'fail' the performance test even though the net return received by most of its members would 'pass' the test. The trustees would then be required to formally advise these members that their product had failed the test, even if they had not. In these circumstances it is likely that the employer who has negotiated the discount in good faith would write to their employees informing them that their superannuation product had not failed the test due to the discount received. The outcome will be confusion as members will receive two communications which present opposite conclusions.

Therefore Mercer recommends that the average of the actual RAFEs for the MySuper product (allowing for discounts) be used in the performance test.

While the use of an average actual RAFE will not represent the actual fee paid by any member of the MySuper product, it will be much closer to reality than the use of the "rack rate" fee. The adoption of actual fees being paid by members will also encourage further fee reduction which is in the members' best interests.

Adjustment for risk

The proposed performance test is based on net return only, taking into account net investment return and administration fees. It makes no allowance for different risks that occur within the same asset class. For example, investments in a speculative mining stock and a conservative "blue chip" stock that pays regular dividends will be benchmarked against the same market index. Whilst this approach is simple, it does not represent the different volatility (or risks) that occur within the same asset class or at the sub-sector level.

Mercer has developed a risk adjusted test that builds upon the proposed use of the net investment return. This is described in the Attachment.

Therefore Mercer recommends that should a product fail the proposed test, a second risk-adjusted test should be applied.

This approach will provide a more robust outcome for assessing and encouraging better outcomes for members as fund trustees would be able to de-risk their investment portfolio under certain economic or market conditions, knowing that the reduced risk would be taken into account before they are deemed to 'fail' the test.

Notification to members

Subsection 60E(6) of the draft bill states that the notice to members must be in the form specified in the regulations and contain information of a kind specified in the regulations. Schedule 2A sets out the required form and information.

However the suggested wording in Schedule 2A would be misleading or wrong for many members. In fact, a financial advisor would not be permitted to send such a letter as it would breach the "Know Your Client" requirements.

There are many examples where a member may be ill-advised to leave a particular superannuation fund, even if it was deemed to be a poorly performing fund based on the proposed performance test. Examples include:

- The employer supports a nominated superannuation fund though payment of the administration fee or insurance premiums. This support may not extend to other superannuation funds.
- The employer has negotiated a discounted administration fee with the superannuation entity which would not be available with another fund.
- There is no mention of insurance. Insurance premiums vary considerably across the industry due to the membership profile of each fund. For many individuals, the insurance premiums paid each year are much higher than the administration fee.
- The desired level and terms of insurance cover may not be available in every fund, particularly for individuals in dangerous occupations, where exemptions or special cover arrangements may apply in the current fund.

The proposed wording also states that "The annual performance assessment compares the earnings of your product ... against similar funds". In fact, this is not the case. There is no comparison in the test against other funds. The test is primarily against the investment benchmark which uses market indices and not other funds.

Therefore Mercer recommends that the wording in Schedule 2A be significantly reviewed and warnings be included that individual circumstances (such as any employer support or insurance arrangements) need to be taken into account before any decision is made to consider a different fund.

The consequences of failure

The current proposed test is that all members holding the underperforming product be informed when a superannuation product fails the proposed test. This member communication has the potential to lead to a 'run' on the fund by the more engaged members leaving the disengaged members to bear the consequences of the failure. That is, the very cohort of members that the Government is seeking to protect are likely to suffer.

The underperformance has not been caused by the action of members. Rather it has been caused by action or inaction of the fund's trustees.

Therefore Mercer recommends that upon the second successive failure, APRA should initiate an Action Plan to improve the governance of the superannuation entity rather than communicate with members immediately.

The Action Plan could include:

a. The appointment of an independent chair of the trustees
b. The tendering of certain outsourced services, where they are causing underperformance
c. The review of relevant investment managers
d. Regular monitoring by APRA

If the entity continued to underperform over the next two years, then a compulsory Successor Fund Transfer could be initiated by APRA.

Comparison rankings

Section 60J(3) of the Bill mentions that the formulas to be used as a basis for ranking "according to relative fee levels, investment returns or any other criterion". Division 9AB.3 sets out the formulas to be used by APRA in calculating the information that the Commissioner of Taxation will then use for the comparison rankings on the website. We welcome that different rankings will be applied in respect of net returns and fees, and that the ranking in respect of fees appear to take into account the individual's account balance.

The comparison tool should also include a warning that past performance is no guarantee of future performance. After all, in 2003 ASIC published Regulatory Guide 53 *The use of past performance in promotional material* which states in Para 8.3 that:

> "It may be **misleading** to imply that reliance on simple past performance figures would be a good way to select a financial product or service." (ASIC's emphasis)

The Guide goes onto comment that:

> "It is good practice to inform potential investors about the level of risk in various investments, where practical."

It would be good practice for the consumer portal to recognise the limitation of a single investment figure.

In addition, given that insurance premiums are a major cost for many fund members, often representing 0.5-1% of their wages, the omission of insurance from the ranking is disappointing.

We recognise that although insurance cover is complex and needs some explanation, its omission is a major weakness from the proposed consumer portal.

Therefore Mercer recommends the portal highlight that insurance premiums and cover can vary significantly between different products and that individuals should review the insurance arrangements, including coverage and premiums, before changing funds.

As always, Mercer welcomes the opportunity to contribute to improving Australia's superannuation industry for members. Please do not hesitate to contact me if you would like to arrange a discussion or need further information in respect of the above matters.

Yours sincerely,

Dr David Knox
Senior Partner

Attachment: A risk-adjusted approach to investment performance

The proposed performance test ignores the concept of risk (or volatility) in investment returns. Yet, in the capital markets, there is a strong correlation between higher returns and higher risk. Mercer has previously highlighted the fact that some funds, which have achieved lower volatility of returns for their members, could fail the test because their return was below the benchmark despite a better risk-adjusted return than the benchmark. This is not a good outcome and is likely to lead to funds following the benchmark without seeking better outcomes for their members.

To highlight this undesirable result, the following graphs show how a product could deliver a good risk-adjusted investment return yet fail the proposed test.

Figure 1 shows that the proposed test is unidimensional and takes no account of risk. It is based on net return only. Figure 2 highlights the relationship between risk and return; that is, as you increase the risk, the returns should also increase. Figure 3 then shows that superannuation products that have low risk, possibly due to their members' characteristics, could fail the proposed test even though their risk-adjusted return could be above expectations. We believe this would be an unfortunate outcome and could be resolved by introducing a second test.

Figure 1 – The proposed test

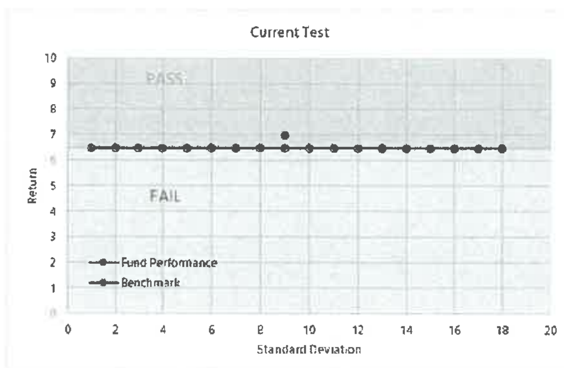


Figure 2 – The risk-return trade-off

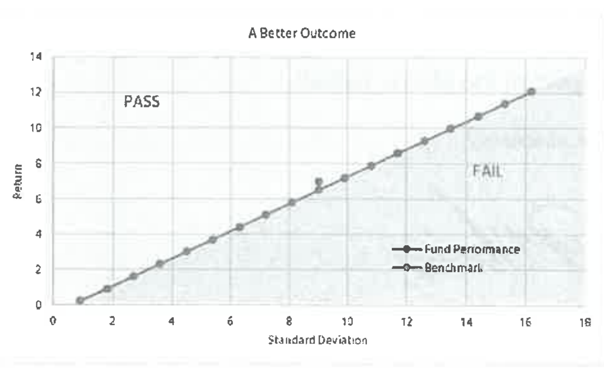
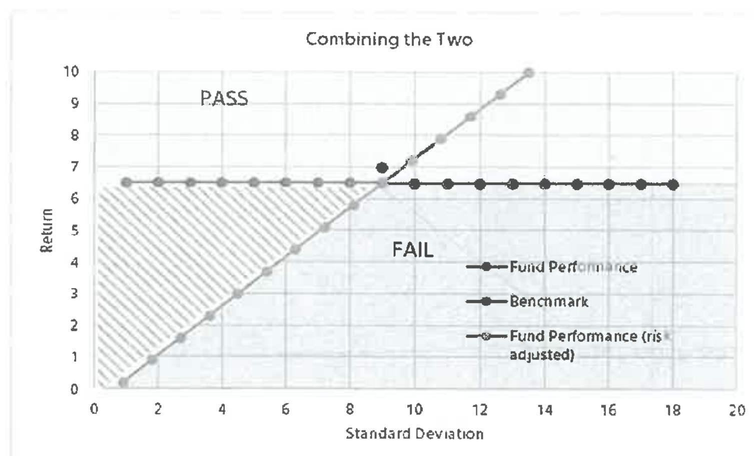


Figure 3 – The problem "shaded area"



We suggest a formula similar to the following could be used to adjust for risk:

{Net Investment Return *minus* (Risk Adjusted Benchmark Return *minus* 0.005) *minus* RAFE Adjustment} > 0

where:

Risk Adjusted Benchmark Return = Benchmark Return x Portfolio Risk / Benchmark Risk

RAFE Adjustment *equals* Product's actual RAFE *minus* Median actual RAFE

Portfolio Risk and Benchmark Risk would be calculated as the standard deviation of the actual portfolio and the benchmark portfolio respectively, which is common practice within the investment industry.

Mercer

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27 May 2021

Subject: **Your Future Your Super Regulations and associated measures, 2021**

Dear Sir/Madam

Thank you for the opportunity to respond to the exposure draft of the *Treasury Laws Amendment (Your Future Your Super) Regulations 2021.*

We previously made a submission dated 25 May 2021 and would like to make this supplementary submission which deals with a few details relating to the draft regulations.

Single Default Account

Section 17A (3) – Tiebreaker requirements

Subsection (3)(c) includes a priority condition relating to the fund that "held the largest account balance for the employee at the end of the previous financial year".

We understand that account balances at the end of the previous financial year may not be reported to the ATO until the following 31 October.

Question: How is the ATO to apply this rule in the period from 1 July up until it receives the 30 June account balance information? For example:

- Is it intended that the ATO will it use account balances from the previous year which may be 15 or 16 months out-of-date such that the nominated account may no longer have the largest balance? Would the current draft regulations require this approach or would subsection (3)(d) which provides the ATO with discretion apply? Our view is that the application of 3(d) in these circumstance would be an unsatisfactory outcome, as the ATO may be required to be used frequently.
- What if the stapled fund request is made in August and only the fund with the smallest balance has reported the prior 30 June balance to the ATO at that time? Does it then become the stapled fund? Again, we submit this would be an unsatisfactory outcome.

Section 17B – Requests to the Commissioner

Section 17B relates to a request by an employer in respect of subsection 32R(3) of the Act where the employer seeks to identify any stapled fund for an employee.

The draft Explanatory Statement implies that section 17B means that an employer cannot ask the ATO for stapled fund details of someone who is not an employee.

However many employers seek to have remuneration and other arrangements including superannuation sorted out for their new employees prior to their start date. Please confirm that section 17B will not prevent an employer asking the ATO for stapled fund details of a new employee prior to their start date.

Recommendation: If required, amend the Bill or Regulations to ensure that employer requests for a future employee prior to their actual start date are permitted.

YourSuper Comparison Tool

Treatment of lifestages

The draft Explanatory Statement states (p.16):

> *"The proposed Regulations prescribe that Part 6A products, including lifestages of products that are lifecycle products, should be ranked in certain ways."*

We cannot see any reference to the ranking of lifestages in draft Division 9AB.3.

Our understanding of the Part 6A product definition suggests that a lifestage is not a Part 6A product.

Section 9AB.23

This draft regulation defines 'test period' to *"mean the period that:*

> *(a) starts at a time that:*
>
> > *(i) is no earlier than 8 years before the start of the financial year; and*
> >
> > *(ii) is the start of a quarter in an earlier financial year; and*
>
> *(b) ends at the end of a quarter in the financial year.'*

This definition is vague and could be interpreted in several ways. For example:

1. There are numerous periods that would meet this definition. The draft ES provides no information on what is expected.
2. Part (a) appears to allow for a test period of up to 9 years, whereas the performance test period is a maximum of 8 years
3. Part (b) appears to allow test periods to end at a date prior to the end of the financial year and therefore for periods to which the performance test does not relate
4. The regulations should require that any comparisons/rankings are based on returns for the same period
5. Also, see below concerning frequency of updates

Section 9AB.24 Fee ranking formula

The formula in this draft regulation specifies that Fee ranking is based on the sum of:

> *applicable investment fee + applicable administration fee + applicable indirect cost ratio*

We note that the applicable indirect cost ratio is based on the "*the relevant beneficiary's account balance in respect of the Part 6A product*" whereas applicable administration fee and applicable investment fee are based on "*an account balance in respect of the Part 6A product*".

Questions:

- Why the different terms?
- What account balance is intended to be used?

The draft Explanatory Statement states on page 16:

> '*Second, products are ranked by total annual fees. Using this method, members are able to see the fees charged by their superannuation fund in comparison to other products managed by other superannuation funds. This comparison will allow members to make informed judgements on the value of the fees that they pay and promote competition between superannuation funds.*'

In our view this is misleading. Members will need considerably more information than a ranking by total fees to make informed judgements on the value of the fees that they pay. The comparison tool should make this clear. For example, higher fees may be required to obtain exposure to certain asset classes that may be expected to provide higher risk-adjusted returns over the long term, so members will need to look at the investment arrangements and returns achieved, as well as the total fees charged, to make an informed assessment.

Sections 9AB.21 and 9AB.22 Frequency of updates

As we read these draft regulations, the 'financial year' used for ranking is a year for which the performance test has been assessed. This would appear to have the following implications given the drafting of the remainder of Division 9AB.3:

- no ranking can be carried out until the 2020/21 performance test has been assessed
- investment return and fee information and ranking can only be updated annually after the performance test for the prior year has been assessed

Questions

- Is this what is intended?
- Alternatively, is it intended that investment return and/or fee information be updated quarterly (and therefore able to be ranked) as earlier announcements appeared to indicate?

If it is the latter, which we would support in order to keep the information as current as practicable, then we recommend that the draft regulations be modified to facilitate this and the comparison tool should make clear that the performance test assessment relates to the previous financial year.

Portfolio Holdings Disclosure

The draft material sets out two disclosure options.

Mercer's preference is Option 1 under which the information prescribed for disclosure specified in the regulations would be uniform across all asset classes.

We consider that Option 1 could be implemented in the timeframe proposed in the draft regulations (i.e. with the first reporting date being 31 December 2021 and portfolio holdings at this date to be shown on fund websites by 31 March 2022), provided that the regulations are made by 30 June 2021 or shortly thereafter.

Option 2 specifies separate and quite granular disclosure requirements for each derivative holding. Due to some of this data not being readily available and its greater complexity, this option would involve greater cost and require a further 6-9 months to implement, depending on when the requirements were finalised.

In our view Option 2 would provide marginal additional value to fund members, not justifying the additional cost and delay associated with this option.

Some details proposed under Option 2 would also require further clarification; for example, it is unclear what credit rating is proposed to be used. Consideration would also need to be given as to whether public disclosure of counterparty credit ratings by super funds would breach their licensing agreements with ratings agencies, or involve some significant additional licensing cost for funds.

As always, Mercer welcomes the opportunity to contribute to improving Australia's superannuation industry for members. Please do not hesitate to contact me if you would like to arrange a discussion or need further information in respect of the above matters.

Yours sincerely,

Dr David Knox
Senior Partner