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SUBMISSION

Submission to Treasury — Annual Superannuation Performance Test: Design Options

19 April 2024

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Superannuation Efficiency and Performance Unit

Retirement, Advice and Investment Division

The Treasury

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PARKES ACT 2600

Via email: YFYS@treasury.gov.au

19 April 2024

Dear Sir/Madam

Annual Superannuation Performance Test: Design Options

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission in response to the Treasury consultation on the Annual Superannuation Performance Test: Design Options.

About ASFA

ASFA has been operating since 1962 and is the peak policy, research and advocacy body for Australia's superannuation industry. ASFA represents the APRA regulated superannuation industry with over 100 organisations as members from corporate, industry, retail and public sector funds, and service providers.

We develop policy positions through collaboration with our diverse membership base and use our deep technical expertise and research capabilities to assist in advancing outcomes for Australians.

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If you have any queries or comments in relation to the content of our submission, please contact Andrew Craston, Director Economics, on 0401 016 587 or by email acraston@superannuation.asn.au.

Yours sincerely

Mary Delahunty

Chief Executive Officer

Summary comments

ASFA welcomes the opportunity to comment on design options to improve the annual superannuation performance test.

ASFA supports the objective of ensuring the best outcomes for superannuation fund members, good governance of superannuation funds and addressing product underperformance. To this end, ASFA supports the need for an objective test that assesses the performance of superannuation products.

Since the introduction of the performance test in 2021, the industry has focused on managing chronic underperformance and has largely succeeded in addressing this.

We welcome the review as a genuine opportunity to acknowledge the original intent of the performance test to improve member outcomes, and to begin a thorough conversation with policy makers about a phased approach to sensible changes that better reflect the full set of factors that determine good outcomes for members.

We support the principles outlined in the consultation paper and believe they can help guide further improvements.

ASFA makes this submission is in four parts. We briefly examine the purpose of the test as it was, and is now. We examine the current test, and we consider both its consequences and potential improvements. Our submission also considers other elements of the consultation paper.

ASFA considers that it is important that the assessment of performance, and the consequences of underperformance, are appropriate and that the out workings of the performance test regime are in the best financial interests of superannuation fund members and support member outcomes. This is consistent with the policy intent of the *Your Future Your Super* legislation when introduced – to address product under-performance, to improve financial outcomes for members, and to enable fund members to better understand their superannuation.[1]

From a broad economy-wide perspective, the performance test regime influences funds' asset allocation decisions, which would be expected to ultimately impact the deployment of financial capital across the Australian economy – including investments in real assets. That said, the extent and quantum of these effects are not well understood.

Given the wide-ranging, and shifting impacts of the performance test regime – on member outcomes as well as the broader economy – ASFA considers that improving the efficacy of the performance test regime should be an ongoing process beyond the current consultation process.

With respect to the current options for improving the performance test regime – as presented in the consultation paper – ASFA considers that the current test should be retained, but with enhancements. In particular, ASFA considers that the most effective improvement would involve reforming the consequences of failure against the performance metric.

ASFA's long-standing policy position is that a review mechanism should be incorporated into the performance test regime for products that fail against the performance metric. Given the imprecise nature of any assessment methodology, and the significant consequences of failing the performance test, the trustee of a product that fails the test (by a specified margin) should be permitted to 'show cause' to APRA as to why the

[1] Treasury 2020, *Your Future Your Super – Reforms to make your super work harder for you.* https://treasury.gov.au/sites/default/files/2020-10/p2020-super_0.pdf

product should continue to be considered to be performing. This is the current approach taken to funds that are considered to be 'Faith Based Funds.'

Beyond the current consultation process, ASFA considers that there is scope to continue to improve the efficacy of the performance test regime. This would include accounting for risk-adjusted returns – which would be expected to reduce the unintended consequences of the current performance test, and the out workings for members, regulators and the broader economy.

ASFA strongly encourages the consideration of barriers to consolidation and mergers of products. Without due consideration of these barriers, the full policy intent of the performance test will not be realised.

While CGT rollover relief currently exists where an entire superannuation fund is transferred to a successor fund, there is no equivalent loss or asset rollover relief with respect to a partial transfer of a sub-set of member benefits to a successor fund, or for the transfer of assets of a particular product or investment option within the same fund.

The lack of CGT rollover relief at the investment option level is a significant barrier to trustees removing underperforming products, particularly wrap platform products. Without tax relief, members would incur tax on capital gains arising on the sale of assets of the underperforming product/option. The member tax consequences can be significant making it difficult for a trustee to determine that it is in members best financial interests to remove the option by transferring the assets to another suitable option in the fund.

Recommendations

1. Consider a phased approach to further improvements that enhance the test approach to include a more holistic consideration of member outcomes, including a measure of total risk-adjusted return.
2. Retain the current form of the test, noting the first recommendation.
3. Introduce a review mechanism
4. Allow additional benchmarks for Choice products where prescribed benchmarks are not sufficiently representative.
5. Allow the full policy intent of the performance test to be realised by removing the barriers to consolidation and extending CGT relief at the investment option level.

General comments

Principles for reform – the importance of member outcomes

ASFA supports the proposition in the consultation paper that primary principle by which to assess the efficacy of the performance test regime is whether the regime improves member outcomes. In this regard, the consultation paper notes the performance test should:

- protect consumers from being offered poor products
- not inhibit funds from investing in the best interests of their members to deliver better long-term returns.

ASFA agrees, however considers that an additional key criterion as to whether the performance test delivers on member outcomes is that the test should avoid mis-identifying products as under-performers – given the significant consequences of failure against the performance metric.

As discussed below, ASFA considers that the risk of mis-identification is a key short-coming of the current performance metric, and indeed of any alternative, solely quantitative test framework. With respect to the current performance test, the most significant potential impact on member outcomes relates to the consequences of failure – that is, that a product would be mis-identified as an under-performing product and that this result would be communicated to members of that product.

Ultimately, through a phased approach, ASFA members would welcome enhancements to the test that more broadly capture the components of good member outcomes. This could include a measure of total risk-adjusted return received by the member.

Performance test reform – consultation paper options

The current performance metric

ASFA considers that the current performance metric is not wholly mis-aligned with member outcomes. As noted in the consultation paper, the current metric – in effect – assesses the efficiency of the implementation of a product's investment strategy. Improvements in this regard would be expected to be supportive of member outcomes.

However, as is also noted in the consultation paper, the current metric has significant shortcomings.

Firstly, it is a fairly narrow aspect of product performance. In particular, the current metric cannot take account of the benefits to members of a product's particular investment or risk management strategy.

Secondly, it influences funds' investment behaviour such that asset allocation and approaches to risk management differ from what otherwise would have been the case (in the absence of the performance test). In particular, in order to manage portfolios against the current performance metric, funds invest with regard to their budget for tracking-error vis-à-vis the prescribed test benchmarks. While products with a relatively large performance buffer (vis-à-vis the portfolio benchmark) can tolerate a larger tracking error budget in the short-term, all products are subject to a (sustainable) long-term tracking error budget.[2] This acts as a constraint on asset allocation decisions.

- To the extent that such constraints result in lower long-term returns for members (than otherwise would the case), is inconsistent with the principle of improving member outcomes. The magnitude of the opportunity cost is empirical matter – the Conexus Institute estimates that the industry-wide opportunity cost of a sustainable tracking error is in the order of $3 billion dollars per annum.[3]

The effects (of needing to manage tracking error) on asset allocation decisions are likely to be more consequential for assets/asset classes that are not well-represented by the existing set of benchmarks – where allocations to affected asset classes would be lower than otherwise (in the absence of the performance test). This includes the broad range of unlisted assets, but particularly unlisted 'greenfield' investments in private equity and infrastructure. From a broad economy-wide perspective, ASFA notes that there is concern within Government that the current performance test risks impeding the allocation of financial capital for investment in real assets necessary for Australia's transition to net zero.

A third, more fundamental concern with the current performance metric – or indeed any set of alternative metrics more generally – is the risk of a product being mis-identified as an under-performer. Products can fail against the current performance metric, not because they are poorly-performing but because of spurious

[2] A 'sustainable' level of tracking error can be defined as a level which provides a trustee a high likelihood of passing the YFYS performance test without having to make sizable portfolio changes through time (David Bell and Trista Rose 2022, *Your Future Your Super Performance Test: Constraint on ESG, Sustainability and Carbon Transition Activities*, Conexus Institute).

[3] David Bell 2021, *Your Future Your Super Performance Test: Constraints and Sustainable Tracking Error*, Conexus Institute.

statistical outcomes. This reflects the fact that certain assets/classes of assets have unstable return distributions (vis-à-vis standard benchmarks), and that performance relative to benchmarks is (necessarily) assessed over a limited time-series of annual data points – this is particularly relevant to the range of unlisted assets. ASFA considers that the risk of a product being mis-identified as an under-performer, and that this result would be communicated to the members of that product, is contrary to the principle of achieving better member outcomes.

Alternative performance metrics

The consultation paper proposes a number of potential alternative metrics (single, or combinations) that would assess product investment strategy – each with particular strengths and weaknesses.

Reforming the performance test to incorporate a metric(s) that account for investment strategy has appeal. In particular, it would address one of the key shortcomings of the current performance metric – that is, the current metric does not account for the impact on member outcomes of a product's investment strategy. Over the long-term, investment strategy is the greatest determinant of ultimate investments returns for members.

However, it is not clear whether an alternative performance metric framework, whether comprising a single metric or multiple metrics, would unequivocally improve member outcomes.

Firstly, the risks of mis-identification and its consequences would remain. This includes for the current performance metric coupled with an additional metric(s), or an entirely new single/multi-metric test. Regardless of the structure/composition of a reformed quantitative test, it is not clear to what degree, the risks of mis-identification would be reduced (it cannot be eliminated).

Secondly, to manage against the current performance metric, funds have adjusted their investment approaches – including asset allocation and risk management. Re-adjusting investment approaches in order to manage against an alternative metric(s) comes at a significant cost for funds – and those costs would be ultimately borne by fund members.

Thirdly, for funds, any multi-metric test would increase the complexity of managing investment portfolios vis-à-vis the test.

Performance test reform – review process

ASFA considers that the most effective improvement to the current performance test regime would involve reforming the consequences of failure against the current performance metric, rather than changing the set of metrics.

ASFA's long-standing policy position is that a review mechanism should be incorporated into the performance test regime for products that fail against the performance metric. Given the imprecise nature of any assessment methodology, and the significant consequences of failing the performance test, the trustee of a product that fails the test (by a specified margin) should be able to 'show cause' as to why the product should continue to be considered to be performing.[4]

[4] For example, see ASFA submissions:
Submission to Treasury - Review of Your Future, Your Super Measures: consultation paper (October 2022).
https://www.superannuation.asn.au/wp-content/uploads/2023/09/202217_Treasury_Review-of-Your-Future-Your-Super_final_sans_signature.pdf

A review mechanism would acknowledge that the current performance metric – or indeed any set of alternative metrics more generally – carries the risk of a product being mis-identified as an under-performer. A further advantage of review mechanism is that is incorporates an aspect of performance assessment absent from any metric – that is, a review can be forward looking. It can take account of changes that trustees have made that would be expected to improve member outcomes – such as improvements to investment governance processes.

Under a review mechanism, APRA would evaluate whether the product has, or is likely to, deliver appropriate member outcomes – and if so, would be permitted to continue to accept new members. Given the key risk of product mis-identification (as described above), APRA could focus it review processes on those asset classes, or particular investment objectives, that are not well-represented by the prescribed benchmarks.

- With respect to the former, this is particularly relevant to the range of various unlisted assets (including property assets, infrastructure assets, private credit, private equity).
- With respect to the latter, this is particularly relevant to choice products – which is discussed in the next section.

Additional benchmark indices

Choice products often have a specific objective, that has been disclosed to members and is the reason why members have chosen that product, which can differ from solely seeking to maximise investment returns over the medium to long term. Such objectives may include; investing in accordance with ESG principles, investing in accordance with particular investment thematics, or capital preservation.

- ESG-orientated products impose limitations on certain assets – including through the use of filters and screens – that preclude investments that meet certain negative criteria or fail to meet specified positive criteria. Broadly speaking, exclusion are either activity-based (e.g. tobacco, weapons manufacture) or conduct-related (e.g. human rights, anti-corruption).
- Over recent years, a key developing investment thematic relates to carbon transition – where assets are selected, weighted or excluded in a way that is consistent with a specified decarbonisation trajectory.
- With respect to retirement products, the Retirement Income Covenant requires trustees to formulate a strategy to balance additional objectives for members who are approaching or in retirement, such as managing risks to the sustainability and stability of retirement income and providing a degree of certainty with respect to drawdowns.

Such products tend to have a higher level of performance test tracking error vis-à-vis the prescribed benchmarks, and have a greater likelihood of failing against the current performance metric (over a given time period).

As such, ASFA considers that the set of benchmarks incorporated within the performance test regime could be enhanced over time to accommodate choice products for which the prescribed benchmarks are not sufficiently representative – including those described above.

Submission to Treasury - Superannuation Performance Test Regulations 2023 (May 2023). https://www.superannuation.asn.au/wp-content/uploads/2023/09/202314_Superannuation_Performance_Test_Regulations_2023.pdf

Additional indices would only be included at a time when they are sufficiently developed. On the particular issue of ESG-related benchmarks, the Treasury consultation paper rightly notes, that while ESG indices have been developed, for many there is still a lack of sufficient historical data.

On a more general point, with respect to the broader set of superannuation products – that includes MySuper products – ASFA does not oppose the incorporation of better, more representative benchmarks that could replace current prescribed benchmarks (as new benchmarks become available). However, as a design principle, ASFA considers that any new benchmark should not apply retrospectivity – that is, a new benchmark would apply only to that portion of a product's performance history that follows the introduction of the benchmark.

Other issues

Administration fees

ASFA considers that administration fees should remain within the performance test regime. For members, improvements in the efficiency of fund operations and member services are consistent with better member outcomes.

ASFA acknowledges that there are a range of views within the superannuation industry regarding the appropriate time period for assessing administration fees in the test – that is, whether the time period should be the most recent twelve months (as is the case currently), or a longer time period that aligns with the time frame for investment assessment.

The administration fee methodology could be refined to better reflect the actual member experience, particularly where a member is invested in multiple investment options and has a relatively high balance. Currently, the performance test assesses the full dollar-based administration fee for each investment option. However, in reality, it is typical for a single administration fee to be charged for a multi-option 'product' (rather than for each investment option). In this regard, ASFA considers that the treatment of fees should be adjusted, such that a proportion of the dollar-based administration fee is assessed based on the average number of options held.

Benchmark indices – fees and taxes

The assumed fees in the listed indices do not account for 'frictional' transaction costs that are generated as funds rebalance exposures to match indices. These costs are material particularly in volatile markets (anecdotally, up to 5 times higher than the assumed fees). This implies that, net of fees, a competitively-priced index products/option can 'under-perform' relative to its benchmark as a consequence of market volatility – and thus 'under-perform' relative to its benchmark, on average, over long time periods (including over a 10-year look-back period as per the performance test).

Both the alternatives and private equity asset classes are benchmarked to listed indices. However, the assumed fees for listed indices are materially lower than the actual, typical cost/fees for investments in alternatives and private equity (by contrast, both the unlisted property and infrastructure asset class benchmarks are net of investment fees). In the context of the performance test, all else being equal, this in effect would increase the required rate of return on investments (net of fees), and would be likely to lead to a lower level of investment in these asset classes than otherwise would be the case.

For Australian listed equities, the assumed tax rate in the performance test remains at 0 per cent. The rationale for this appears to be that the tax expense will, over the long-term, equate to the value of franking credits. However, this will not be the case. Indeed, the differential could result in a material difference between the benchmark net return and the actual net return (including where generated from the implementation of an efficient passive investment strategy). This justifies the inclusion of a higher assumed tax rate for Australian listed equities (around 5 per cent). ASFA acknowledges that the performance test allows for gross investment returns net of fees (as well as net investment returns), which has the potential to provide flexibility for funds where data for realised tax is incomplete.

Removing barriers to consolidation – CGT relief

As recommended in previous ASFA submissions, to achieve the policy intent of removing underperforming products, there is a need to address existing barriers to consolidation and mergers of products. Superannuation wrap products are inherently different in nature and use to MySuper products. They offer a menu of investment choices through a single account. Access to many wrap platforms is only available to members through the implementation of personal advice.

- In a Media Release on 10 November 2021 entitled *APRA urges super members to prioritise their own best financial interests*, APRA noted that data collected from the 13 failed MySuper products showed that from the one million member accounts in products that failed the test, fewer than 68,000 had been closed. That accounts for 7 per cent of total accounts in the failed products, or only 4.2 per cent ($2.2 billion) of assets.

To address this, ASFA strongly recommends the government extends CGT relief to the transfer of assets in a product / option.

Since the introduction of the performance test, trustees of MySuper products falling short of the test have been able to make decisions in the best interests of the members of those funds and this has often led to the closure of the fund and merger activity. Capital gains tax is not payable where the entire fund is merged into another fund – relief is provided. The relief removes tax impediments to mergers between complying superannuation funds by permitting the roll-over of both revenue gains or losses and capital gains or losses.

In comparison, where performance issues are identified in a Choice investment option, a trustee may determine that transferring members to another option may provide a solution. However, no CGT rollover relief is currently available for a trustee directed transfer of assets of an identifiable product or investment option within a superannuation fund.

The absence of CGT relief for a trustee directed transfer of assets of an investment option within the fund significantly limits trustees' ability to manage underperforming investment options in the best financial interests of all members holding the option. Further, the tax consequences are also a barrier to financial advisers recommending that a member transfers out of the underperforming option.

The inconsistent application of tax relief between MySuper products and wrap style options can result in effectively locking existing members into legacy products that have been closed to new members.

Extending CGT rollover relief to apply for the transfer of assets of a product/option within the fund would not only address this barrier to removing underperforming products but would also be expected to increase efficiencies and reduce costs to members thereby improving member outcomes.

Trustee-directed products – treatment of 'arms' length' products

The definition of TDP should not include 'arms' length' products where the trustee has no control or influence over the design and implementation of the investment strategy of the product.

Under the scope of the TDP definition, the set of products ranges in complexity from multi-sector products that are MySuper-like (and may constitute a member's total superannuation investment), to multi-sector options that may be used in combination with one another or with non-TDP investment options. Further, the superannuation product structure through which members hold TDPs can vary, including different styles of platforms (from master trust arrangements to wraps). This latter point is particularly relevant in terms of how fees and taxes are determined for, and levied on, member accounts – for example, whether fees and taxes are determined at the collective level, or determined and levied for each individual member. This greater complexity should be reflected in the performance test – where practicable – and in the letter members where a product has failed the test.

Previous ASFA submissions have raised concerns with the scope of TDPs within the performance test regime.[5] The definition of TDP includes where the trustee invests in a product offered by a 'connected entity'. This can include both 'arms' length' products, which are available for other trustees to offer on their platforms and may be available to non-superannuation investors, and 'non-arms' length' products where the trustee may maintain influence. With the former the trustee has no control or influence over the design and implementation of the investment strategy of the product. Given this, that makes an 'arms' length' product more akin to an externally directed product, which are not included in the Test.

[5] Submission to Treasury - Superannuation Performance Test Regulations 2023 (May 2023). https://www.superannuation.asn.au/wp-content/uploads/2023/09/202314_Superannuation_Performance_Test_Regulations_2023.pdf