Mercer

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Subject: **Annual Superannuation Performance Test - design options**

Dear Sir/Madam

Mercer welcomes the opportunity to respond to the Treasury Consultation paper entitled *Annual Superannuation Performance Test – design options* dated March 2024.

The structure of this submission is as follows:

- Who is Mercer?
- Our major recommendations
- Some introductory comments
- Detailed comments supporting our recommendations

Who is Mercer?

Mercer believes in building brighter futures by redefining the world of work, reshaping retirement and investment outcomes, and unlocking real health and well-being. Mercer's approximately 25,000 employees are based in 43 countries and the firm operates in 130 countries. Mercer is a business of Marsh McLennan (NYSE: MMC), the world's leading professional services firm in the areas of risk, strategy and people, with 85,000 colleagues and annual revenue of over $20 billion. Through its market-leading businesses including Marsh, Guy Carpenter, Mercer and Oliver Wyman, Marsh McLennan helps clients navigate an increasingly dynamic and complex environment.

Our superannuation trustee services and the Mercer Super Trust work with employer clients and retail brands to bring a comprehensive suite of personal superannuation services and financial advice to their workforce and members. Mercer Australia also provides customised administration, technology and total benefits outsourcing solutions to employer clients and superannuation funds, including industry funds, master trusts and employer-sponsored superannuation funds. Mercer provides investment consulting and research services, implemented consulting and is a multi-manager of structured investment solutions. Mercer has a strong history of partnering with institutional asset owners, endowments and foundations, financial advisers and family offices to help them achieve their investment goals.

Our major recommendations

- The current performance test should remain as the primary test with some adjustments to certain benchmarks to provide better representation of particular asset classes.
- A second test should be introduced to review the performance of those Trustee Directed Products which fail the primary test. This would not apply to MySuper products. The introduction of a second test, together with changes to fee measurement (see next recommendation), would not represent an overall weakening of the purpose of the performance test. Rather the goal is to improve the robustness of the test, recognising that the same style of test is not relevant for all products.
- The current fee measurement should be extended from the last 12 months to the last two years, thereby reducing the opportunity for gaming and strengthening the test.
- The performance test should not be extended to single-sector products, retirement products or externally-directed products.
- The communication provided to members of Trustee Directed Products that fail the test should be reviewed to better represent the actual situation facing these members.
- A technical working party comprising members of Treasury, APRA and the superannuation industry should be established to improve the consistency of the implementation of the test.
- Provision should be made in the legislation that the test should not be applied in a year where there has been significant market disruption. Application of the test under such circumstances is likely to cause further disruption and an unnecessary loss of community confidence in superannuation.

Some introductory comments

Our initial comment is that MySuper products and Trustee Directed Products (TDPs) are very different in their underlying characteristics and the level of member engagement. MySuper is a default product, that is well defined in legislation and where members do not need to make a decision. In our compulsory superannuation system, it is appropriate that MySuper members are protected from under-performance and/or over-charging. On the other hand, members invested in TDPs have a made a decision to move away from the default MySuper product. The reasons for these decisions are many and varied ranging from personal ethics and morals regarding certain investments to a consideration of their overall personal financial position, including assets outside superannuation. In other words, some TDPs are selected for a particular reason.

Hence, while a similar test may be applied to these two types of products, we recommend that the consequences of failure should be different. That is, failing the test should lead to a stronger response and more significant consequences for a MySuper product than for a TDP.

It must be recognised that the performance test affects Trustee behaviour as the consequences of failure is significant. The test also affects investment decisions when the benchmark used is incomplete or does not fully represent the available investment opportunities, in Australia or globally. Such effects may not always be in the members' best interests. Hence, the test needs to be made more robust than is possible with a single test with specified benchmarks.

Detailed comments supporting our recommendations

Maintain the current test with some minor improvements

The Consultation paper outlined several design options for the annual superannuation performance test. As the paper showed, none of the presented options are perfect and they all have specific advantages and disadvantages.

Given the absence of a “perfect” test and that any change to a different test would inevitably create disruption to the investment markets and to member outcomes, Mercer recommends continuation of the current test with the following adjustments:

- The current benchmarks for the following asset classes do not adequately represent the specific asset class and we therefore recommend the following changes:

Asset class	Recommendation
International Unlisted Infrastructure	Use a global index, ex Australia. That is, do not use the same index as for Australian Unlisted Infrastructure
Emerging asset classes (e.g. timber, agriculture)	Use a CPI plus index over the long term until an appropriate index is available
Private equity	Use Public Market Equivalent which typically uses Long-Nickels method of calculation

- It is inevitable that investment markets will develop and change over time. Therefore, to ensure that the benchmarks remain appropriate and relevant, Mercer recommends that the benchmarks be reviewed every three years.

Mercer also recommends that all changes to the benchmarks should operate on a prospective basis only. This approach would have two important advantages:

- There would be no introduction of unexpected retrospectivity.
- New data could be collected that is relevant to the new benchmarks on a go-forward basis. Such historical data may not be available.

The introduction of a second test for TDP failures

As outlined in the Consultation paper, there is no perfect test to assess the performance of the large range of TDPs that are available in the market. It is inevitable that some Type I errors will occur. That is, there will be false positives in which TDPs are deemed to have failed the test despite delivering outcomes consistent with their purpose. Such a result would be unfortunate for both the provider and the members concerned. It may also threaten the credibility of the performance test, or to put it in colloquial language, such a result may not pass the “pub test”.

Hence, Mercer recommends a second test should be applied to those TDPs that fail the standard test. Of course, there are many options that could be used, but Mercer recommends that a peer-comparison test be applied, similar to option 2b in the Consultation paper. As noted in the paper, one of the drawbacks of this test is that there is no agreed industry view of what constitutes a ‘growth’ or defensive’ asset. However, given this would be a second test designed to remove any outliers that should not be considered a failure, this drawback is less important when used for this purpose.

We are only recommending the introduction of a second test for failed TDPs and not for failed MySuper products, for the reasons outlined earlier.

Testing period for fees

Mercer has never advocated that the testing period for fees should be the same as the period used for investment performance. After all, investment markets are affected by economic cycles and therefore should be assessed over the longer term. On the other hand, fees are set out in the PDS and are broadly known in advance.

However, Mercer recognises that it is possible to adjust the fees paid during the year and thereby influence the results of the performance test. Therefore, Mercer recommends that the RAFE should be measured over the last two years and not just the preceding 12 months. This outcome would represent a reasonable balance between the overall purpose of the test and the need to discourage certain gaming of the system.

No extension of the test

Mercer does not support extending the performance test to single-sector products, retirement products or externally-managed products for three quite different reasons.

As the Consultation paper notes, “The current test was only designed to apply to multi-sector accumulation products.” (page 32) Hence it was not designed for single-sector products. These products have very different features to multi-sector products and may be selected by members for particular reasons or purposes, sometimes in consultation with their financial advisor. As the paper also notes, trustees have less ability to influence the outcomes when compared to multi-sector products. In effect, a different test would be required, and the appropriate test is likely to vary by asset class. A significant expansion of benchmarks would also be needed to appropriately cater for the wide variety of single-sector products currently available. For all these reasons, Mercer does not support extending the performance test to single-sector products.

Retirement products have very different features from accumulation products. While an account-based pension may appear similar to an accumulation product, the cash flows are very different. Money is not only withdrawn on a regular basis but can also be withdrawn as lump sums, as needed by the retiree. Cash flow management is therefore very important and will be determined, at least in part, by the ages of the retirees.

In addition, Retirement products may include longevity protection, capital protection and inflation protection which mean that valid and robust comparisons are virtually impossible. It should also be noted that the impact of the Retirement Income Covenant continues to evolve.

Finally, and as noted in the Consultation paper, the retirement market is still in an emerging and developmental phase. Performance tests influence trustee decisions and any extension of the test to the retirement phase will inevitably affect product development and innovation. This would be a very unfortunate outcome.

For the reasons outlined above, Mercer does not support extending the test to cover retirement products.

Externally-managed products represent a very different structure to Trustee Directed Products with trustees having very limited influence on the outcome. It would be very difficult to construct a test that considered the range of available externally-managed products in a fair and robust manner. Therefore, Mercer does not support extending the test to cover these products.

Communication to members in failed TDPs

One of the current consequences of failing the performance test is the requirement to inform members in a prescribed format of the result. This can be very confusing to members, particularly for those who have made a personal choice decision to invest in a particular TDP.

For example, an increasing number of members are choosing to invest in a no-carbon or sustainability option, in line with their personal preferences. In certain market conditions, it is likely that these investment options will underperform when compared to the benchmarks. The communication to these members under such circumstances should require trustees to explain the reasons for the results and offer members the opportunity to switch options. However, the trustees should also be able to note that such an action may be contrary to the member's previous preferences.

Another example where the current communication is confusing is where a Successor Fund Transfer (SFT) is in progress. That is, members have been informed of a future change but then, as a result of a performance test failure, another communication is required which makes no mention of the forthcoming SFT.

Mercer therefore recommends that the required communication in respect of TDPs that have failed the performance test be amended to make the communication more appropriate and relevant to the affected members.

Establish a technical working party

The implementation of the annual performance test raises many issues that go beyond the design options discussed in the Consultation paper. These issues include the application of stitching in a range of different circumstances as well as the definition of a Trustee Directed Product. It is important that decisions relating to these topics are applied consistently and encourage improved member outcomes. This may be particularly relevant as sub-scale or under-performing funds are consolidated with larger or better-performing funds.

Mercer therefore recommends that a technical working party comprising members of Treasury, APRA and the superannuation industry be established to improve the consistent implementation of the performance test.

Allowing for a significant market disruption

From time to time, it is inevitable there will be significant market disruption in the capital markets. Such disruption may be caused by the outbreak of war, a global pandemic, a significant fall in the market value of certain assets, a significant change in global interest rates, etc.

While it is impossible to predict or define such future events, Mercer recommends that there should be a provision to suspend the annual performance test under these situations. That is, such circumstances are likely to generate much broader social and economic issues that need to be considered by the Government and/or the financial regulators. Application of the test under these circumstances is likely to cause further disruption and an unnecessary loss of confidence in the superannuation industry.

Naturally, we would be very happy to discuss any of these comments with you and your team as you carefully consider these matters.

Yours sincerely,

Dr David Knox AM
Senior Partner