Actuaries Institute.

19 April 2024

Superannuation Efficiency and Performance Unit
Retirement, Advice and Investment Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: YFYS@treasury.gov.au

Dear Sir/Madam,

Consultation paper: Annual Superannuation Performance Test – design options

The Actuaries Institute (Institute) welcomes the opportunity to provide feedback on the Treasury consultation paper on potential longer-term reform options to the design of the annual superannuation performance test (Test).

The Institute is the peak professional body for actuaries in Australia. Our members have had significant involvement in the development and management of superannuation in Australia, and work across APRA regulated funds, SMSFs and public sector funds.

The consultation paper summarises well the concerns the Institute and others share with the Test. As the Test stands, its design and the importance of passing are influencing trustees' investment decisions to the potential detriment of long-term returns for members.

Now that the Test sets a minimum bar for a product's right to remain in line with the intent of the Productivity Commission's recommendations, the Test should remain. Consequently, the Government is right to examine ways in which the Test can be improved to facilitate better retirement outcomes for Australians.

In summary, we support a transition to a targeted two-metric Test, with one metric as the existing Test metric and the other metric a measure of the product's performance on a risk-adjusted basis. This single adjustment would meaningfully align the Test with a trustee's overarching duty to act in the best financial interests of their members.

We set out on the following pages our key comments and, in the Attachment, our specific responses to many of the questions raised in the consultation paper.

Reform Principles

We *support the four key principles proposed when assessing potential changes to the testing framework.* However, *we do not believe it is possible for any 'bright line' Test applied at the investment option level to effectively meet all four of these principles*.

Member outcomes from superannuation primarily depend on the choice and combination of investment options selected by the member (or the default investment option selected by the trustee), as well as the benefits and fees from the service and features (e.g. insurance cover) provided by their fund. It follows that

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it is not possible to design any singular 'bright line' investment option focused Test that fully assesses, and therefore improves, outcomes for most members. However, an investment option test is a good proxy for member outcomes for the many members who only use a default MySuper product, as the MySuper sector caters for members who are predominantly wholly invested in a low-cost product and who have not made any active investment or insurance choices.

Some merit in maintaining the status quo despite the current Test's limitations

The Test as it currently stands arguably meets many aspects of the key principles.

The Test is effective at identifying significant trustee underperformance for those investment options that underperformed against their disclosed strategic asset allocation benchmark. However, the Test can also misidentify well-performing investment options, e.g. it is possible for an option with an above median risk-adjusted net return to fail the Test. Further, the Test is limited to assessing historical net investment performance, and therefore disregards any changes made by a trustee that improve the prospect of future performance.

The Test can be and has been efficiently applied by APRA within two months from the end performance date and clearly communicated to members in failing investment options one month thereafter.

The Test is transparent and applicable to the superannuation products where the policy rationale for a 'bright line' investment option test is most suited: MySuper investment options.

If the Test is left as a set and forget, it would then of course endure. This is consistent with managing superannuation as a long-term asset for retirement and has the benefit of providing trustees with certainty around how to ensure the products they offer to members pass the Test. In that sense, it is a "known risk" that can be managed by trustees without further direct costs (i.e., major asset sell-downs that occurred in 2020-21 in asset classes that did not align well to the benchmark asset classes and prescribed indices).

In our strong view however, outside MySuper, the current Test fares relatively poorly at improving member outcomes given its narrow focus on assessing performance of investment implementation. There is therefore an implicit (and difficult to quantify) indirect cost to members if funds are managing their tracking error to confidently pass a test that is not strongly aligned with maximising retirement outcomes.

For these reasons and the transition risk of performance test reform, ***we see some merit in retaining the status quo approach despite the Test's limitations, especially for MySuper products***.

Alternative single-metric tests would not meet policy objectives

Alternative single-metric tests have benefits but also drawbacks and retain many of the high-level issues with the current Test – i.e., backwards-looking, no overlay of the reasons for underperformance (and whether these are systemic), and with retrospective application. If an alternative single metric replaced the current Test, it would create a new set of winners and losers. Like the current Test, it would risk failing 'good' investment options along with the 'poor' options. The Institute therefore does not support their introduction in place of the existing Test.

An appropriately designed multi-metric test has the most merit

Changes are warranted to improve the sophistication to a multi-metric test so that good performance is more accurately distinguished at an investment option level. Broadening the inputs to the 'bright line' test would provide some avenue for wider considerations than the existing Test. It would reduce the inherent risk of 'false positives' for investment options that fail the Test but which are not genuinely underperforming and provide good member outcomes.

Our advice is to transition to a targeted two-metric Test. Given the desire to ensure reform minimises disruption to long-term trustee decision making and member outcomes, the existing Test should continue as one of the metrics. To align the Test with a trustee's overarching duty to act in the best financial interests of their members, ***an additional metric should be added to measure the product's performance on a risk-adjusted basis***.

Incorporating a risk-metric to the Test would represent a substantial improvement to the status quo because the Test could then better cater for investments and investment strategies that do not naturally align with the prescribed asset classes and chosen indices that are constrained under the current benchmarking approach (for example, ESG focused investments and investment strategies). Both risk-adjusted returns compared to peers (Option 2B in the consultation paper) and risk-adjusted returns relative to a Simple Reference Portfolio (SRP) frontier metric (Option 2C in the consultation paper) are good approaches that should be explored in more detail along with further consultation from an implementation perspective. While Option 2B has the distinct advantage of enabling disclosure of a risk-exposure metric (percentage of growth assets) that can be understood by consumers, Option 2C addresses the Option 2B's key drawback of not requiring a potentially contested methodology to classifying assets into a binary growth/defensive classification. However, Option 2C magnifies existing issues (and therefore the need to address them) around the lower observed volatility of unlisted assets as compared to listed assets.

Like the current Test, the risk-adjusted metric should ensure sufficient weighting is placed on fees by testing investment performance after accounting for both investment and administration fees. This also avoids the risk of any gaming in trustees classifying different fee types to pass the performance test.

Passing the Test would require passing at least one Test metric. This design is proposed so that trustees can continue to have confidence around decisions they have already made to ensure they pass the current Test while also encouraging them to pursue investments more closely aligned with the best financial interests of their members on a forward basis. Concern that designing an "either or" pass criteria weakens the Test could be addressed by calibrating the 50bps threshold required to pass the Test. This is an area that should be subject to further consultation. It is also important that the Test is not framed in a way that suggests that the current benchmark test metric is the 'primary' metric, with the product only tested against a 'secondary' metric if it first fails the 'primary' metric. Such a hierarchical test design would incorrectly suggest that how well a trustee has implemented its strategic asset allocation is more important than whether the trustee has achieved good risk-adjusted returns for its members.

Broader considerations for reform

No additional product coverage. We do not recommend the Test's expansion to more investment options such as retirement products, single sector or externally managed options and Self-Managed Superannuation Funds (SMSFs). As outlined earlier, the Test only provides protection from investment underperformance in a narrow way and so is most suited to MySuper products. Its expansion to Trustee-Directed products may have acted to reduce member outcomes, and expanding the Test to more products would further constrain investment management in a way that risks harming members' retirement outcomes.

If the Test's coverage is left as is, the Institute believes that consumers would not be worse off given the combination of other regulatory frameworks in place such as APRA prudential standard *SPS 530 Investment Governance* (to ensure investment options are monitored and reviewed for investment performance and suitability), *APRA Prudential Standard SPS 515 Member Outcomes and Strategic Planning* (to ensure products are offered in a holistic way that continue to promote the best financial of members) and the ASIC administered Design and Distribution Obligations (DDO) Framework (to ensure products are designed and distributed appropriately in that they represent good value to members). Further, for retirement phase products, managing risks to the sustainability of retirement income and ensuring flexible access to capital are important considerations alongside investment performance, and the Test would adversely impact a trustee's ability to properly discharge its obligations under the Retirement Income Covenant.

Retain existing approach to assessment of fees but apply a higher representative account balance of $100,000. The current 12-month lookback approach for administration fees is not only a better indication of expected future fees than a ten-year lookback but has also been very successful in lowering MySuper product fees to the benefit of members (particularly for those that have balances close to $50,000). However, this threshold was set more than a decade ago. As median member balances continue to increase, a higher representative member balance of $100,000 would be more appropriate for the Test (and likely for PDS disclosure) than the existing $50,000 figure. In the case of members in platform products, we would recommend that the Test be designed to reflect that a representative member is likely to be closer to $250,000.

No reduction of consequences for the Test for MySuper products but some changes for choice products. We support the current consequence framework in the context of MySuper where many members are placed in a suitable product by default. However, the choice sector, by nature, requires members to be more engaged and actively involved in their product selection. Service levels and the fees charged in the choice sector are also higher than in MySuper. We see a greater role for trustees and APRA in how areas of choice option underperformance are understood and rectified beyond simply an investment option test. We believe that the consequences for failing the Test for choice products could instead require trustees to provide to APRA (and implement) an action plan to address the underperformance, including determining if/when underperforming options will be closed.

Recognise barriers to consolidation of some choice products and reduce these barriers where possible. For platform choice products, tax considerations act as a significant barrier to consolidation. For other taxed choice products, legislation prevents trustees from moving members to new products (rather than new investment options within the product) without member consent. We recommend that Government permit CGT roll-over relief so that trustees can more easily perform intra-product transfers (on a similar basis to successor fund transfers) to help trustees form a view that an intra-product transfer is in members' best financial interests.

An appropriate transition for phasing in any changes to the Test to minimise disruption to Trustee investment management processes, costs and adverse outcomes to members. While designing an appropriate transition will naturally depend on the direction and scale of reform decided by Government, it is critical that performance test reform take a forward-looking posture by not retrospectively penalising trustees for decisions previously taken. For example, if benchmark changes are made, we recommend they are applied prospectively (i.e., the existing benchmarks continue to apply for prior years). Any movement to a multi-metric test or expansion to the Test beyond MySuper and Trustee-Directed investment options should provide sufficient forward notice once the design has been finalised.

Ensuring that changes to the Test flow through in how outcomes of the Test are disclosed to members on the ATO YourSuper Comparison Tool. We recommend that the Comparison Tool is improved by disclosing a risk-metric to consumers**.** The current Comparison Tool labels products that "passed" or "failed" the Test but fails to disclose to consumers any measure of the underlying investment risk of each product. This is important given existing products, particularly beyond MySuper but also between MySuper products, vary widely in the risk that is pursued in investment strategies.

The Institute would be pleased to discuss this submission. If you would like to do, please contact me on (02) 9239 6100 or public_policy@actuaries.asn.au.

Yours sincerely

(Signed) Elayne Grace
CEO

Attachment: Detailed responses to selected consultation paper questions

Principles

Consultation Question

1. Do you agree with these principles? Are there any other principles that should be considered?

The Institute supports the key principles in the consultation paper.

However, **we do not believe it is possible for any 'bright line' investment option focused Test to meet the key principles outlined in the consultation paper**, given the conceptual limitations that accompany this approach. These include:

- It ignores other aspects of member outcomes, which depend on the combination of investment options selected by the member and the service and features provided by the product and the fund.
- The Test looks at past performance and does not look at changes that improve the prospect of future performance.

As such, the Productivity Commission's initial recommendation that the Test form part of a broader annual member outcomes assessment was more appropriate.

However, the simplification to a 'bright line' test is most applicable to those members who use a default MySuper product. As these members are more likely to be wholly invested in a single MySuper investment option, an investment option test for MySuper incorporating an administration fee adjustment is a good proxy for these members' actual member outcomes (albeit that the Test still only looks at past performance, and not those changes that improve the prospect of future performance).

Now that the Test sets a minimum bar for a product's right to remain, we believe the Test must remain despite its inherent limitations. Consequently, we believe that the Government is right to examine ways in which the Test can be improved.

Status quo – SAA Benchmark Portfolio

Consultation Questions

2. Is assessing the implementation of a strategy, as opposed to assessing the choice of strategy itself, a strength or weakness of the current framework?
3. Can the existing methodology be materially improved, such as by further calibrating benchmarks, to largely address unintended consequences? How could these improvements overcome the incentive to benchmark hug, and remove barriers to invest in emerging asset classes?
4. What asset classes do you consider require better coverage in the test? What asset classes are covered well by the existing test?
5. Do you consider additional indices covering additional asset classes should be added to the test? If so, please provide the following details for **each** of your recommendations:
    a. Description of asset class
    b. Name of recommended index covering the above asset class, including the length of time data is available on the index
    c. Details of appropriate fee and tax assumptions for such an asset class
    d. Explanation of why you consider this index is appropriate for inclusion
6. How should the test cater for new asset classes in the future?
7. Should the threshold for failure be recalibrated for some products? What evidence supports the need for a different threshold? How could a different threshold deliver better long term returns to members?
8. Would retaining the current framework but moving to a simpler structure, such as a simple-reference portfolio of only bonds and equities, address some of the concerns with the current test?

Assessing implementation of an investment strategy is a good metric but to make this the sole determinant of underperformance is not good policy from a member outcomes perspective nor how a consumer would expect such a test to work. The Test as it applies under the status quo:

- Has retrospective effect – trustees did not know that implementation of investment strategy over the preceding several years before the Test applied would have such potential existential consequences for their perceived performance. However, now that the Test is in place, these retrospective impacts have largely been dealt with, albeit with several otherwise better performing investment options (by other measures) being forced to close to new members.
- Ignores the strategic asset allocation of the option – this is the greatest determinant of member outcomes.
- Does not consider actual relative risk adjusted net returns – a more conventional measure of member outcomes.
- Requires trustees with investment options close to failing the Test to measure shorter-term tracking error against benchmarks, thereby constraining investment decisions, and potentially reducing member outcomes. This inhibits these options from investing in new emerging asset classes like ESG specific investments.

- Has greater consequence and hence greater priority than other measures which focus on member outcomes such as the annual outcome assessments.

Were the Test to be replaced by an alternative single-metric test, this would potentially address some of the Test's weaknesses. However, we believe that it is not possible to create an appropriate single metric test that meets the key principles set out in the consultation paper.

Having said the above, we make the following points in support of retaining the status quo Test (with potentially further refined benchmarks):

- The impact of the Test is now known, and replacing the current benchmark test metric will simply create another set of winners and losers – trustees can now manage to the Test whilst members can be assured that Government and regulators take firm action against those investment options that underperform against the Test.
- The Test is clear and objective – it does not require subjective assessments such as how a particular investment is classified or how risk is measured.

The changes made to the granularity of the Test benchmarks introduced for the 2023 Test have reduced the tracking errors previously faced by some investments and have improved the Test at the margins. However, it created retrospective changes to the Test outcomes, and if benchmark changes are made, we recommend they are applied prospectively (i.e., the existing benchmarks continue to apply for prior years). We caution against reform to simplify the existing Test as fewer asset benchmarks would increase the risk that otherwise good investment strategies adversely track and cause Test failures.

Alternative single-metric test -Risk-adjusted returns

Consultation Questions

9. Would the Sharpe ratio be a more appropriate testing approach than the current framework? Would this lead to better member outcomes?
10. How should the benchmark for performance be calibrated?
11. What data should be used to estimate the Sharpe ratio, and how frequently?

A Sharpe ratio Test would address some of the concerns of the status quo Test but introduces others. We do not support its introduction as a single metric given the:

- Need for a consistent source of data.
- Variability caused by how and how frequently unlisted assets are valued.
- Impact of broader market forces, causing 'good' products to fail along with 'bad' products.
- Creation of new winners and losers relative to the existing Test, and the likely retrospective application of the revised Test.

Consultation Questions

12. Are either of these approaches better than the existing test methodology (option 1) or a simple Sharpe ratio (Option 2a)? Are there any other considerations that make this a better or worse option?
13. Are there any other alternative single-metrics that would be superior in addressing the principles set out in this paper? How would they provide a better testing framework? What net benefits do they provide over other proposed metrics?
14. What incentives would these alternative single-metric options provide trustees, and what would be the consequence of this for member outcomes?

The consultation paper describes and critiques two alternative approaches to the existing Test or the Sharpe ratio. These are peer comparison of risk-adjusted returns, and risk-adjusted returns relative to a simple-reference portfolio. We support the paper's analysis.

There are benefits and drawbacks to both alternative single-metric measures. Whilst it could be argued that they would have been better than the status quo Test had they been chosen when the Test was first introduced, we believe that changing the Test to either of these alternative approaches has drawbacks, not least the creation of new winners and losers relative to the existing Test, and the likely retrospective application of the revised Test. However, a metric of this nature has merit as part of a multi-metric test.

Multi-metric test

Consultation Questions

15. Would greater alignment to the APRA heatmaps improve the sophistication of the test?
16. Would it reduce incentives to benchmark hug and improve member outcomes?
17. Is correlation between metrics an issue? If so, how should this be addressed?
18. Should the test capture all the metrics in the heatmap? If not, what metrics?
19. How would the benchmark for performance be calibrated for chosen metrics? How would these metrics combine to determine overall pass/failure of the test?
20. What costs would be associated with aligning the test to the heatmap? What would be the benefits?

The APRA Heatmaps combine investment option specific metrics and fund level metrics. We believe that fund level metrics such as fund growth are best addressed as part of the annual outcomes assessments by the trustee considered at a fund level.

Whilst the remaining three APRA Heatmap metrics could be adopted as part of a multi-metric option, we agree with Treasury's assessment that many of these metrics are correlated with one another and that too many metrics introduce unnecessary complexity to the Test's design. Instead, we recommend a more targeted multi-metric test that has less correlation between the APRA Heatmap metrics (see below).

Consultation Questions

21. Would this framework improve the sophistication of the test? Would it reduce incentives to hug benchmarks and improve member outcomes?
22. Would this approach be more, or less, favourable than the heatmap approach?
23. What would the costs of implementing this approach be? What would the benefits be?
24. Are these the right measures of performance or are there other more important indicators of performance that should be measured in addition to or instead of those outlined? What metric should be used to assess these indicators?
25. How should the benchmark for performance be calibrated?

A multi-metric framework for the Test has appeal if structured appropriately. It would broaden the inputs to the 'bright line' Test and provide some avenue for wider considerations that the existing assessment of implementation against strategic asset allocation.

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We see strong merit in a targeted two-metric Test. Given the desire to ensure reform minimises disruption to long-term trustee decision making and member outcomes, the existing Test should continue as one of the metrics. To align the Test with a trustee's overarching duty to act in the best financial interests of their members, we recommend that ***an additional metric is added to measure the product's performance on a risk-adjusted basis***.

Incorporating a risk-metric to the Test would represent a substantial improvement to the status quo because the Test could then better cater for investments and investment strategies that do not naturally align with the prescribed asset classes and chosen indices are currently constrained under the current benchmarking approach (for example, ESG focused investments and investment strategies).

Both risk-adjusted returns compared to peers (Option 2B in the consultation paper) and risk-adjusted returns relative to a Simple Reference Portfolio (SRP) frontier metric (Option 2C in the consultation paper) are good approaches that should be explored in more detail from an implementation perspective along with further consultation. While Option 2B has the distinct advantage of enabling disclosure of a risk-exposure metric (percentage of growth assets) that can be understood by consumers, Option 2C addresses the Option 2B's key drawback of not requiring a potentially contested methodology to classifying assets into a binary growth/defensive classification. However, Option 2C magnifies existing issues (and therefore the need to address) around the lower observed volatility of unlisted assets as compared to listed assets.

Like the current Test, the risk-adjusted metric should ensure sufficient weighting is placed on fees by testing investment performance after accounting for both investment and administration fees. This also avoids the risk of any gaming in trustees classifying different fee types to pass the performance test.

Passing the performance test would require passing at least one test metric. This design is proposed so that trustees can continue to have confidence around decisions they have already made to ensure they pass the Test while also encouraging them to pursue investments more closely aligned with the best financial interests of their members on a forward basis. Concern that designing an "either or" pass criteria could be addressed by calibrating the 50bps threshold required to pass the Test. This is an area that should be subject to further consultation.

It is also important that the Test is not framed in a way that suggests that the current benchmark test metric is the 'primary' metric, with the product only tested against a 'secondary' metric if it first failed the 'primary' metric. Such a hierarchical test design would incorrectly suggest that how well a trustee has implemented its strategic asset allocation is more important than whether the trustee has achieved good risk-adjusted returns for its members.

We also comment on the 'implementation of promise to members' metric that has been posited in the consultation paper. We note it can be linked to some sound concepts and existing trustee obligations:

- The 'investment promise' to the member is linked to the investment covenant on superannuation trustees. As per the SIS Act, trustees must set, effect and review an investment strategy for the fund as a whole and each investment option, having regard to among other things the trustee's objectives.

- The enhanced SPS 530 Investment Governance requirements that came into effect from 1 January 2023 requires each trustee to set appropriate 'performance benchmarks' and methodology for each product that are 'specific' and 'measurable' to help beneficiaries select investment options. At the investment option level, these performance benchmarks must be approved by the Board. However, these performance benchmarks are not necessarily (or fit for purpose to be) disclosed to superannuation members.
- MySuper product dashboards require trustees to set 'return targets' for each MySuper product, defined as the 'mean annualised estimate of the % net return of a representative member that exceeds the growth in CPI over 10 years'. With some changes like redefining what is a 'representative member', this concept could be applied to other Choice accumulation products.
- Trustees report this sort of 'performance promise' data to APRA already. Under SRF 705.1 table 1, trustees must report for each investment option the investment performance benchmark (for example, CPI), the return margin compared to the benchmark, and the investment horizon that the benchmark refers to.
- The investment promise disclosed to members (risk / return) information as part of PDSs then fall under ASIC's disclosure regime that among other things need to be clear, concise and effective, and not misleading nor deceptive. Consumers are also more likely to intuitively understand this kind of metric - "is the product meeting the performance my trustee has promised me"?

However, this metric cannot be easily implemented without further (perhaps substantial) changes to the current superannuation legal framework. Risk-return targets disclosed to members are not necessarily promises in the sense that they are 'investment guarantees' for which it would be reasonable to hold trustees to account for. Furthermore, we would expect in times of market downturns, every product with CPI + X return target would likely fail this metric (converse applies in market upturns). We envisage this would unnecessarily undermine Australian's long-term confidence in their superannuation. We therefore do not believe this metric would meet the key principle of being sufficiently enduring.

Alternative frameworks

Consultation Questions

26. How would an alternative framework be constructed according to the elements outlined above? Please provide specific details.
27. How would this framework more effectively advance the principles outlined in this paper?
28. What would be the costs and benefits associated with this framework, compared to the current test and any other alternatives?

We do not propose any other alternative framework, other than potentially retaining the status quo for MySuper options, and transitioning to our proposed two-metric test for other investment options assessed against the Test.

Broader considerations for reform

Consultation Questions

29. What are the most important considerations for performance of retirement products?
30. If the test were to expand to retirement products, would they require a different test to the accumulation phase? Would the test differ for different retirement products?
31. How could longevity products be most appropriately assessed? How could the products be compared?

Retirement income products are by their very nature different from accumulation superannuation products. Unlike accumulation products where the primary product features affecting outcomes for all members are investment returns after all fees, retirement products require consideration of investment sequencing, investment market, inflation and longevity (both individual and pool) risks. This leads to a need for a wide array of retirement income products (or product options within an umbrella product) to meet heterogeneous member needs and risk profiles. It follows that ensuring members understand the distinguishing features and potentially differing outcomes when choosing and combining between different types of retirement income products is more important than adopting a ‘bright line’ investment performance test within similar types of retirement income products.

Therefore, we believe any retirement income tests or comparisons should be at the ‘member level’ targeting the three objectives under the retirement income covenant: level of retirement income, associated risk to the sustainability and stability of the retirement income, and flexible access to retirement savings. This differs from the ‘product level’ approach applied to compare accumulation superannuation products that focus on fees and investment returns. As indicated by APRA’s proposals to enhance *SPS 515 Strategic Planning and Member Outcomes,* trustees will soon be required to consider whether products are performing from a retirement income covenant perspective when conducting annual outcomes assessments.

In addition, following the introduction of the retirement income covenant, there is an increase in innovation in retirement phase investment products. Introduction of a performance test for retirement products could constrain this innovation.

Consultation Questions

32. Do you agree that retirement phase, single-sector and externally-managed products are suitable for testing? Why or why not?
33. Should different assessment methods be applied to different cohorts of products?
34. Do you agree that the ‘other products’ outlined above are unsuitable for testing? If you think the ‘other products’ (or a sub-section of these products) are suitable for testing, how could they be appropriately tested?
35. Under each design option, how could the test accommodate cohorts that are suitable for testing? For example, using different metrics or benchmarks for performance for different cohorts.

For the reasons set out above, we counsel strongly against introducing a performance test for retirement products. This is primarily because of the indirect costs of trustees being required to manage to a performance test that is not well aligned to member outcomes in the retirement phase, which would stifle innovation intended to maximise member outcomes in retirement.

Given the many drawbacks with the Test, we also recommend against expansion of the Test to additional products (e.g. single-sector and externally managed investment options), until the Test is made more sophisticated and there is evidence to suggest that concerns such as the convergence of investment strategies with the current Test have been dealt with. This will not disadvantage consumers, so long as trustees properly monitor and review all their investment options for performance and suitability under APRA prudential standard *SPS 530 – investment governance*.

We also support that SMSFs are not captured by the Test for the reasons set out in the consultation paper.

Consultation Questions

36. How should fees be measured under each design option?
37. Should fees be measured at the current option level, or should they be measured on a different level? How would this be achieved?
38. Are the current assumptions made in comparing fees acceptable? For example, should the $50,000 representative member balance be adjusted based on the median member balance for a product cohort?
39. Is a peer comparison of fees the best way to measure fees? Is there a better approach to benchmarking fees? If so, how should this work?
40. What product cohorts should be considered? How should different cohorts be defined where products could meet multiple cohort definitions, such as single-sector retirement products?
41. How many years of fees data is appropriate to test? Should a greater weighting be given to certain years?

The application of the Test is at investment option level (for better or worse). The Productivity Commission did not recommend inclusion of the administration fee in its performance test recommendation, and its inclusion at investment option level creates the difficulties outlined in the consultation paper. However, its inclusion and assessing the last 12 months' administration fee in the Test has likely positively impacted on member outcomes more than any other aspect of the Test. Using current fees is not only a better indication of expected future fees than using historical fees, but the approach has also been very successful in lowering MySuper product fees to the benefit of members. The average MySuper RAFE has reduced from 36 basis points (bps) to 27 bps since the Test's introduction - a benefit of 9 bps additional net return to MySuper members. We therefore strongly support continued use of a 12-month lookback period when assessing fees.

As median member balances continue to increase, a higher representative member balance of $100,000 would be more appropriate for the Test (and likely for PDS disclosure) than the existing $50,000 figure. In the case of members in platform products, we would recommend that the Test be designed to reflect that a representative member is likely to be closer to $250,000.

Consultation Questions

42. Should the consequences be adjusted to improve outcomes for members? How would this need to be tailored for the different options for performance testing?
43. How should the consequences be amended to better account for edge cases or different cohorts that fail the test for reasons beyond the trustee's control?
44. How could these provisions be effectively ring-fenced so that it applies only to the edge cases and not failures at large?
45. How could this be achieved without subjecting the regulator to undue challenge and impacting the efficiency of the regime?
46. What other remediation processes could occur?

We support the current consequence framework in the context of the default MySuper product market which are designed help members defaulted into a failing product be moved into a more suitable product.

By nature, however, the choice sector requires members to be more engaged and actively involved in their product selection. As a result, we see merit in a greater role for trustees and APRA in how areas of genuine choice option underperformance are understood and rectified. This is necessary to address the inherent risk of 'false positives' for investment options that fail the Test but which are not genuinely underperforming and provide good member outcomes.

Subject to feasibility and efficiency in conducting the Test, the Institute proposes that the consequences of failing the Test are revised for choice products to instead require trustees to provide to APRA (and implement) an action plan to address the underperformance, including determining if/when underperforming options will be closed. This would limit the operational burden on APRA but allow it to focus its efforts on those investment options for which there are deficiencies in investment performance and for which the trustee is not taking appropriate action. APRA already adopts this posture when engaging with trustees with significantly underperforming products as identified in its superannuation heatmaps.

A key improvement to the prescribed member notice should enable it to be adjusted by the trustee to disclose to its members in the failing product what actions the trustee is taking to address underperformance.

Consultation Questions

47. Are there any key barriers to consolidating closed and underperforming products? What quantitative evidence is there of these barriers? How do these weigh against other reasons a person may choose to remain in a product?
48. What evidence do trustees use to demonstrate that remaining in a closed and underperforming product is in the best financial interests of members, compared to moving to a performing product?
49. What is the process or criteria that trustees use when deciding on what product they will transfer members to when consolidating underperforming products?
50. Should APRA receive increased regulatory powers to direct superannuation trustees to consolidate underperforming products?

Whilst it is relatively straightforward to move members between unitised investment options in the same product within an existing industry fund or master trust, there are still barriers to move members between products without member consent, or where there are tax implications of moving investment option. This can be to the disadvantage of members in legacy products where there are better performing products.

For platform choice products, tax considerations act as a significant barrier to consolidation, and as a result, we believe that it may well be appropriate that members remain in an existing option that fails the Test.

For other taxed choice products, legislation prevents trustees from moving members to new products (rather than new investment options within the product) without member consent. We recommend that this barrier be removed, and trustees be allowed to perform intra-product transfers on a similar basis to successor fund transfers where it believes that the transfer is in members' best financial interests.