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Annual superannuation performance test: Submission by Super Consumers Australia

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Super Consumers Australia is the people's advocate in the superannuation sector. Super Consumers Australia advances and protects the interests of people on low and middle incomes in Australia's superannuation system. It was founded in 2013 and received funding for the first time in 2018.

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Introduction

A strong and objective performance test must remain in place, with broad coverage of the superannuation system. As a compulsory savings scheme, it is incumbent on the government to ensure that members are protected from underperformance. The Productivity Commission estimated that over a working life, poor performance can leave a full-time worker $660,000 worse off in retirement.[1]

Performance testing is a core consumer protection for over 18 million superannuation accounts.[2] A system-wide and publicly disclosed ‘bright line’ performance test helps ensure that super funds are focused on delivering returns which improve people’s retirement outcomes. A robust test also enables the regulator to hold funds to account for member outcomes.

Since its introduction in 2021, the annual performance test has significantly improved member outcomes in the MySuper segment. 12 of 13 funds that failed the first test have since left the industry or merged into a higher performing fund, which will leave their 842,000 members much better off in retirement.[3]

To date, the performance test has had little time to impact on the widespread underperformance in the choice segment, where in 2023 there was $4 billion and 60,000 member accounts invested in products that failed the performance test. Significant underperformance also likely persists in large parts of the super industry which so far have been excluded from performance testing, including the retirement phase and untested choice options.

No performance test will ever be perfect. While the superannuation and funds management industries have criticised the current test because of the theoretical possibility that a ‘good’ product could fail (a false positive), public policy should put greater weight on minimising the probability that underperforming products pass the test (a false negative).

Super Consumers Australia supports retaining the current performance test, with targeted extensions and enhancements to improve its effectiveness in delivering consumer outcomes. In addition, stronger consequences are needed for products that fail the test, especially in the choice segment.

[1] Productivity Commission (2018), “Superannuation: Assessing Efficiency and Competitiveness”, Inquiry Report No. 91, p. 11.
[2] Tested products in the 2023 performance test included 14.3 million MySuper accounts and 4 million choice accounts.
[3] The remaining fund, FirstChoice Employer Super, has subsequently passed the performance test. Super Consumers Australia analysis based on APRA (2023), “Annual MySuper Statistics back series”.

Super Consumers Australia

Summary of Recommendations

Recommendation 1: Conduct an independent review of the superannuation performance test every 5 years. These reviews should be scheduled in advance.

Recommendation 2: Require APRA to publish an analysis each year of investment performance at the asset-class level for products subject to the performance test. This analysis should compare asset-class level returns to the relevant indices used in the the performance test benchmark to assess whether there is widespread evidence of index 'hugging'.

Recommendation 3: Do not give special treatment to investments based on environmental, social and governance (ESG) objectives in the performance test.

Recommendation 4: Broaden the climate-related disclosure requirements outlined in the Treasury Laws Amendment Bill 2024: Climate-Related Financial Disclosure and expand the scope of entities so all registrable superannuation entities with products on public offer must comply with the new sustainability disclosure obligations.

Recommendation 5: Before proceeding with any specific changes to the performance test metric, publish analysis and evidence of how the alternative metrics would apply to existing MySuper and choice products, based on data collected by APRA.

Recommendation 6: Ensure the performance test metric remains an objective measure of long-term investment performance, does not give discretion to super funds or regulators in how the test is applied, and minimises scope for gaming by super funds.

Recommendation 7: Amend the performance test to cover administration fees (relative to a benchmark) calculated at three representative balance levels. These representative balances should be set in a way that aligns with the distribution of member account balances for each product segment, with the middle representative balance reflecting the median member account balance.

Recommendation 8: Adopt a common benchmark median administration fee for MySuper and non-platform choice products in the performance test.

Recommendation 9: Introduce mandatory customer service standards for super funds which reflect community expectations.

Recommendation 10: Extend the existing performance test to account-based pensions and transition to retirement products from 1 July 2024.

Recommendation 11: Establish a process for designing an appropriately adapted performance test for retirement products that are not account-based pensions, to ensure there is a minimum standard that all products must meet. This should be done within 2 years.

Recommendation 12: Extend the existing performance test to all externally managed multi-sector choice products from 1 July 2024.

Recommendation 13: Consider extending the performance test to single-sector choice products, unless there is clear and compelling evidence that it would be impossible for a member to construct an appropriate investment portfolio using only products that have passed a performance test.

Recommendation 14: Require APRA to publish data on the investment performance of single-sector choice products, including performance relative to the relevant indices in the performance test.

Recommendation 15: Require super funds to prominently disclose performance information to all choice members. This information should compare investment performance at the member account level to the benchmark used in the performance test. Funds should be required to send prescribed communications to each member whose performance falls below this benchmark.

Recommendation 16: Require funds to report information to APRA and ASIC about the number of member accounts that perform above and below the benchmark used in the performance test, and the products they are invested in.

Recommendation 17: Improve the prescribed letters sent to members of products that fail the performance test by undertaking targeted consumer testing (informed by behavioural insights) and explicitly prohibiting funds from including any communications in their fail letters other than the prescribed text.

Recommendation 18: Require funds with products that fail the performance test to display a prominent notice on their website homepage until the product has passed the test, or is no longer offered.

Recommendation 19: Notify people in underperforming products, via a message in their MyGov inbox, that their product has failed the performance test.

Recommendation 20: Work in consultation with consumer groups to extend the ATO YourSuper Comparison Tool's product coverage to choice products, and ensure the tool complies with the Australian Government's digital service standards.

Recommendation 21: Legislate to oblige trustees of products that repeatedly fail the performance test to transfer existing members to a different product that has passed the performance test (including in a different fund, if necessary). This should be done within 12 months. APRA should be empowered to intervene by directing a transfer of members to a better fund if the trustee is unable or unwilling to find an appropriate product. Members should be given the option to transfer their savings elsewhere if they do not wish to be transferred to the replacement product.

Recommendation 22: Consider how reforms to the default allocation model (including a 'best in show' list) and continued improvements to the YourSuper comparison tool can help to drive healthy competition that lifts outcomes for all superannuation members.

Policy principles

Super Consumers Australia supports the policy principles described in Treasury's consultation paper. Specifically, we think that the performance test should:

- set an objective 'bright line' that holds funds to account, gives clear guidance to both funds and regulators, and gives Australians confidence that their superannuation savings will be protected;
- prioritise the interests of members and require super funds to earn the right to remain in the compulsory super system—this means putting more emphasis on minimising the risk that underperforming products will pass the test than on minimising the risk that middling products will fail;
- give funds incentives to deliver strong long-term net investment performance and to improve outcomes for members in products that fail, without compromising other outcomes (such as quality of member services) or creating opportunity for funds to game the test;
- be sector-neutral and applied as widely as possible; and
- put the onus on funds and regulators, rather than on members individually, to take action to ensure all members in underperforming products receive better outcomes.

To help ensure that the test remains fit-for-purpose and enduring, it should be subject to periodic independent reviews (every 5 years). These reviews should be scheduled in advance.

Recommendation 1: Conduct an independent review of the superannuation performance test every 5 years. These reviews should be scheduled in advance.

Test metrics

The current performance test

The current performance test has delivered significant benefits for superannuation members, especially in the MySuper segment. While there is clear evidence that it has improved member outcomes, there is little or no firm evidence that some of the unintended consequences asserted by industry have materialised. Some sectors of the superannuation and funds management industries have been vocal opponents of the performance test from the outset, and resistant to being held accountable for the investment decisions they make using members' money.

The performance test appears to have strengthened funds' focus on delivering long-term returns that beat a comparable market benchmark. This is an intended and desirable impact of the test. A key advantage of the current test is that it uses a benchmark which is objective (requiring no discretion from the regulator) and exogenous (derived from broader financial markets rather than from the superannuation industry). This means that poor performers cannot wriggle out of being sanctioned for their performance, and cannot hide among their peers.

We have not seen firm evidence that the test has caused funds to abandon good investment approaches in favour of 'hugging' the asset-class indices in the test. The test allows for the fact that investments in some asset classes may perform above or below the relevant index for short periods of time, and also includes a generous 0.5 percentage point margin of error. This gives funds significant flexibility in how they invest and those that can deliver long-term returns to members will perform favourably in the test. Moreover, it appears that almost three-quarters of MySuper products and non-platform trustee-directed products (TDPs) passed the 2023 test with a margin of 0.5 percentage points or more (i.e. a test metric of 0 or higher), suggesting that they have little need to hug the benchmarks in order to pass.[4]

To enhance transparency on how super funds are investing, APRA should publish an analysis each year of investment performance at the asset-class level for products subject to the performance test. This analysis should compare asset-class level returns to the relevant indices used in the the performance test benchmark to assess whether there is widespread evidence of index 'hugging'.

The main disadvantage of the current test is its focus on testing investment implementation of strategic asset allocation rather than the overall returns generated from the asset allocation itself. While a test that benchmarks absolute returns would be better aligned with member outcomes, it is unclear how such a test could be implemented in practice, given the limitations of alternative metrics we discuss below.

Recommendation 2: Require APRA to publish an analysis each year of investment performance at the asset-class level for products subject to the performance test. This analysis should compare asset-class level returns to the relevant indices used in the the performance test benchmark to assess whether there is widespread evidence of index 'hugging'.

Investment in ESG

There have been suggestions, mainly from parts of the industry, that the performance test should be changed to specifically favour investments in the green energy transition, social housing or other environmental, social and governance (ESG) objectives.

There is no evidence that the test is impeding good ESG investments by super funds. ESG investing is widespread in the superannuation sector, with most of the largest funds adopting ESG philosophies or offering ESG-specific products. The media regularly reports on new ESG investments being made by large super funds. Further, the significant presence of ESG-driven investors in the market implies that the market-wide indices used in the current performance test benchmarks are already shaped by ESG considerations. The performance test effectively

[4] Analysis by Super Consumers Australia based on APRA data.

rewards funds that make good ESG investments that earn strong long-term returns or manage risks across the portfolio if they are able to beat the indices in the benchmark.

The ESG nature of a product should not be an excuse for poor long-term performance. Giving special treatment to ESG investments in the performance test would not be consistent with the objective of superannuation if it erodes members' retirement balances. There is a significant volume of evidence that ESG investment funds can deliver similar returns to conventional funds.[5]

Affording special regulatory treatment to ESG investments would be particularly harmful if it enabled funds to make poorly considered and risky investments based on a single prescriptive view of what the green energy transition will look like. This could lead to members losing significant amounts of money if the energy transition does not end up unfolding in the predicted way.

Likewise, super funds should not be afforded special treatment for pursuing ineffective divestment strategies that come at the cost of members' retirement balances (as opposed to more effective engagement-led ESG strategies). Research on divestment has found that to effect a more than 1% change in the cost of capital, impact investors would need to make up more than 80% of all investable wealth.[6] In an Australian context, no super fund or collection of funds come close to this mark. The reality is that by choosing to divest from non-ESG investments, many funds end up selling the assets to other investors who may not value ESG outcomes, with no obvious net benefit in terms of ESG outcomes or members' retirement balances.

From a practical perspective, introducing ESG-specific benchmarks risks almost doubling the number of benchmarks in the test, given that ESG-style investments exist across almost all asset classes (except for cash). Significantly increasing the number of benchmarks in the test risks effectively giving super funds a free pass for investing in poor-performing types of assets. Taken to the extreme, if each asset had its own bespoke benchmark then no product would ever fail, regardless of whether members receive strong investment returns.

There are also ongoing concerns about potential misrepresentation of ESG products, with wide variation in what funds consider ESG investing to look like and several instances of 'greenwashing' being pursued by ASIC.[7] The Government's proposals to improve the quality of

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[5] For example, International Monetary Fund (2019), Global Financial Stability Report, Chapter 6, https://www.elibrary.imf.org/display/book/9781498324021/ch006.xml; Atz, U. et al (2022), "Does sustainability generate better financial performance? Review, meta-analysis, and propositions", *Journal of Sustainable Finance and Investment*, vol. 13(1), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3708495

[6] Berk, J. B. and van Binsbergen, J. H. (2022), "The Impact of Impact Investing", Scalia Law School Research Paper Series No. 22-008, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3909166

[7] See for example ASIC Deputy Chair Sarah Court's Keynote address "ASIC's 2024 enforcement priorities in the superannuation sector", Connexus Super Chair Forum, 1 February 2024, https://asic.gov.au/about-asic/news-centre/speeches/asic-s-2024-enforcement-priorities-in-the-superannuation-sector

climate-related financial disclosures will help, but need to be strengthened by covering a wider range of ESG issues and extended to all super funds regardless of size.[8]

Recommendation 3: Do not give special treatment to investments based on environmental, social and governance (ESG) objectives in the performance test.

Recommendation 4: Broaden the climate-related disclosure requirements outlined in the Treasury Laws Amendment Bill 2024: Climate-Related Financial Disclosure and expand the scope of entities so all registrable superannuation entities with products on public offer must comply with the new sustainability disclosure obligations.

Alternative metrics

Super Consumers Australia is open to alternative metrics being explored for the performance test, provided they align with the policy principles set out above and will materially improve outcomes for superannuation members compared to the current test.

However, we have several reservations about the alternatives identified in the consultation paper, as set out below. Before proceeding with any changes to the performance test metric, Treasury should publish analysis and evidence of how the alternatives metrics would apply to existing MySuper and choice products, based on data collected by APRA.

Recommendation 5: Before proceeding with any specific changes to the performance test metric, publish analysis and evidence of how the alternative metrics would apply to existing MySuper and choice products, based on data collected by APRA.

Alternative single metrics

We are concerned that alternative measures that include volatility in the performance test metric would give super funds an incentive to invest in ways that compromise, rather than enhance, long-term investment performance. This is because:

- Volatility is not the same as risk. For most superannuation members, the most important risk is not having enough savings during retirement—not the risk that asset values go up and down in the short term. Volatility only compromises financial outcomes for members when returns are (significantly) negative at times when members withdraw money or move their balance into conservative investments. Commonly used measures such as standard deviation (used in the Sharpe ratio) are a poor proxy for this, because they focus on short-term ups and downs in asset prices, and treat gains and losses symmetrically.

[8] For more detail, see our joint submission with the Consumer Policy Research Centre, "Climate-related financial disclosure: Exposure draft legislation", 9 February 2023, https://superconsumers.com.au/wp-content/uploads/2024/03/CPRCSCASubmission_ClimateDisclosuresExposureDraftLegislation-1.pdf

- Including volatility in the performance test would give funds a clear incentive to focus on reducing volatility at the expense of long-term returns. For example, a fund might choose a volatility-return trade-off that has lower returns than they would under the current performance test. This would discourage funds from appropriate risk taking that delivers strong investment returns over the long term, which would not be consistent with the objective of super.
- Measuring volatility for unlisted assets in a consistent way that cannot be gamed will be very difficult. If measured volatility is lower for unlisted assets compared to listed assets, the test would create a strong incentive for funds to over-invest in unlisted assets. This could occur because unlisted asset valuations are made or verified through third-party consultants who value the asset without the noise from market sentiment. It could also arise from the less frequent revaluations of unlisted assets compared to listed assets. Given many super funds already have high proportions of unlisted assets,[9] measurement issues are likely to significantly distort any test metric that includes volatility.

In addition, the Sharpe ratio (option 2a) and simple reference portfolio (SRP) frontier (option 2c) methods in the consultation paper test a risk-return tradeoff but do not clearly establish a realistic alternative that members could have been invested in ex ante. It will only be known ex post which combination of asset classes will have produced the best risk-adjusted returns. By comparison, the current performance test compares long-term investment returns to what a member would have received had they simply invested in products that track the relevant market indices – and therefore sets a clear reference point for funds.

For the simple peer comparisons metric (option 2b) and SRP frontier (option 2c), there is a question about what functional form would be most appropriate for estimating the frontier, and how this methodological choice would affect which products pass or fail the performance test. The estimated frontier could also be distorted by outliers, especially when there are relatively few observations across some growth-asset ranges. If methodological choices are delegated to APRA, then there is also a risk that any decisions it makes will be challenged by funds that face failing the test.

Further, as the consultation paper notes, there is no agreed industry view on how to define growth and defensive assets, which for option 2b invites the risk of funds gaming their test result by subjectively classifying assets.

A further complication with the alternative single metrics is how life-cycle products are to be treated. For example, if each individual lifestage is assessed, how would these be aggregated to a product-level metric? Many lifecycle products to date have delivered disappointing returns to members, often leaving them worse off than had members been invested in single-strategy

[9] Super Consumers Australia analysis of strategic asset allocations for MySuper products in September 2023 shows that many products have high allocations to unlisted assets, with a median allocation of 20%.

MySuper products.[10] Lifecycle products must remain subject to rigorous and objective performance testing.

Multi-metric tests

Multi-metric tests have some appeal as being able to objectively measure performance while avoiding potential distortions and gaming that can arise from using a single metric. However, it is currently unclear how an effective multi-metric performance test could be designed in practice, given the limitations of the alternative metrics discussed above. A multi-metric test that allowed funds with poorly performing products to pass the test would be a bad outcome for consumers.

Further, multi-metric tests and scorecard-style assessments can be subjective and invite disputes on the weights that are given to components. There is a real risk that test outcomes are driven by the weights, which in turn invites funds to structure their investment operations and fees in an attempt to game the test. The challenges with setting weights would be greater the more metrics there are in the test.

Further, we do not support any performance test that superannuation products could pass on the basis of non-investment metrics (e.g. passing based on fee and sustainability measures but not on investment metrics). This would risk leaving members hundreds of thousands of dollars worse off in retirement.

Regarding the APRA heatmap measures, we do not support using measures of account growth rates, cash-flow ratios or rollover ratios in the performance test. These are measures of a fund's sustainability and not of an individual product's investment performance or fees. It makes more sense to measure investment performance and fees directly. This is especially relevant in the choice sector where there are many products with a small number of members.

We strongly oppose any form of subjective test where funds can set their own benchmarks, such as the CPI+X or cash+X metrics contemplated in the consultation paper. Even with regulatory guidance on how these targets are to be set, it is likely funds will find a way to set benchmarks that they will always pass. The incentives to game the benchmark are too strong for it to be left to funds' discretion.

Two-stage tests

A variant of a multi-metric test is a two-stage test, where products that fail an initial first stage metric are subjected to a second stage, and only if the product also fails this second stage is it deemed to have failed the overall performance test. In principle, this may offer a way to address the risk of a good or middling fund failing the initial test. It would also allow the first-stage test to be set in a way that captures a broader set of potential underperformers (e.g. by removing or reducing the 50 basis point margin for error in the current test).

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[10] Song, D. (2024), "MySuper decade shows 'mixed' verdict on lifecycle products", Investment Magazine, https://www.investmentmagazine.com.au/2024/03/mysuper-decade-shows-mixed-verdict-on-lifecycle-products/

However, for a two-stage test to deliver better member outcomes, the second stage should be closely targeted at aspects of investment performance that are not captured in the first stage. It cannot simply be a ‘second chance’ metric that allows poor performing funds to pass the performance test, especially if it lacks objectivity by giving either funds or regulators discretion about how performance will be measured or which benchmarks are used. These are the same reasons why the government’s aborted attempt to introduce a subjective second-stage performance test for faith-based products would have been harmful for super members.

Recommendation 6: Ensure the performance test metric remains an objective measure of long-term investment performance, does not give discretion to super funds or regulators in how the test is applied, and minimises scope for gaming by super funds.

Administration fees

Super Consumers Australia strongly supports including administration fees in the performance test, given the potential for high fees to significantly erode retirement balances.

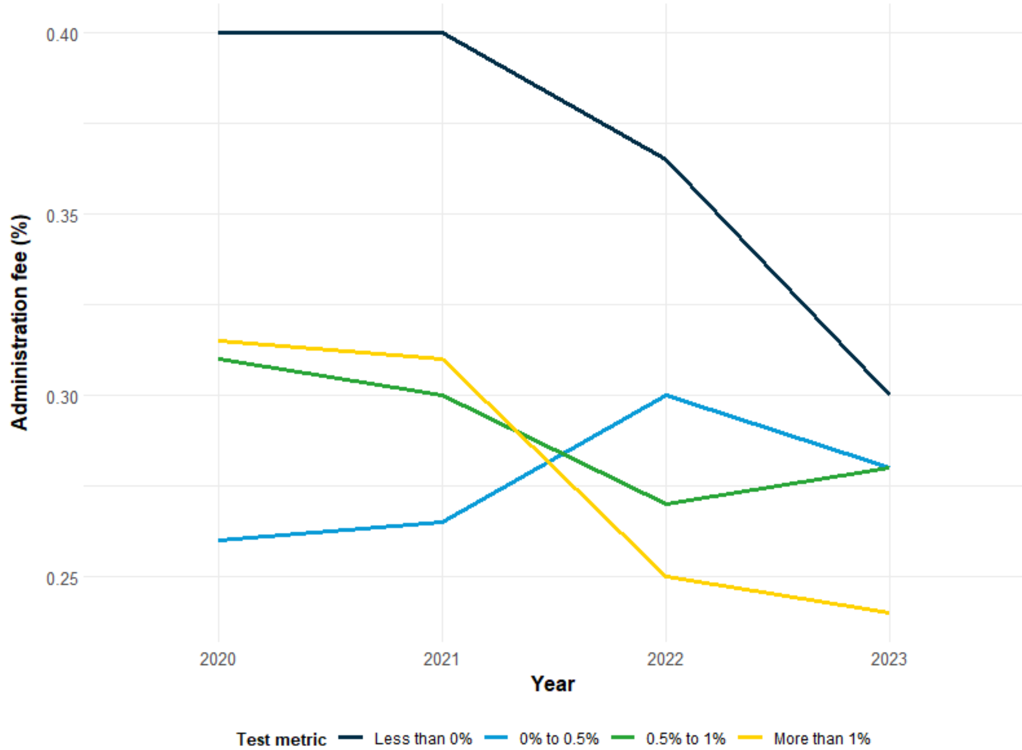
The inclusion of only the current year’s administration fees in the test gives funds a strong incentive to keep their administration fees low, and pushes them to exercise restraint in funding expensive services that only a small number of members may use (e.g. intrafund advice). Current administration fees are also a good predictor of future member outcomes because, unlike investment performance, administration fees are known in advance.

The effectiveness of the current approach is evidenced by the decline in administration fees across MySuper products. The median administration fee of MySuper products fell from 0.36% in 2020, prior to the test’s introduction, to 0.26% in 2023 (for a $50,000 account balance).[11]

Chart 1 below shows the median administration fee for MySuper products grouped by their performance test metric each year.[12] It is evident that the decline in administration fees has been greatest for products that either failed or came close to failing the performance test (test metric less than 0%), but a decline also occurred for the highest performing funds in the industry (test metric more than 1%). Median administration fees across groups are now within a much tighter range, of 0.24% to 0.30% for a $50,000 balance.

[11] Super Consumers Australia analysis based on APRA data.
[12] For administration fees in 2020, we grouped funds according to the 2021 performance test metric.

Chart 1: Median MySuper annual administration fees (for a $50,000 account balance)[13]



It is not yet clear how effective the performance test has been in reducing administration fees in the choice segment, as data for 2024 is not yet available. However, given the very high level of administration fees in this segment, especially for platform products (where median fees in 2023 were 0.54%, twice the level for MySuper products and non-platform trustee-directed products[14]), we expect that these fees will be reduced. This will have a substantial benefit for members.

One downside of the current treatment of administration fees in the test is that funds at risk of failing have an incentive to attempt to reclassify administration expenses as investment expenses, given the test metric uses investment expenses over a 10-year period (in calculating net investment returns) compared to one year for administration fees. To avoid gaming, there needs to be robust regulation and continual regulator oversight of how funds classify expenses and set fees. There is also a possibility that funds may seek to use reserves to artificially suppress their administration fees for a short period if they are at risk of failing, and then subsequently increase the fees (although there is no clear evidence this has occurred to date, at least for MySuper products).

To balance these incentives with the benefits of having a forward-looking indicator of administration fees, consideration could be given to extending the treatment of administration fees in the test to a two or three year historical period. This change could be announced in

[13] Data sourced from APRA (2023), “Quarterly MySuper statistics”, September 2023; APRA (2023), “The 2023 annual superannuation performance test outcomes”; APRA (2021,2022), “MySuper Heatmaps”.
[14] APRA (2023), “Insights paper - 2023 Performance Test”

advance to discourage funds from increasing administration fees before the change comes into effect.

Further, the use of a single representative balance (currently $50,000) to calculate administration fees for the test may create an incentive for funds to structure their dollar and percentage-based administration fees in a way that gives them favourable treatment on the test. To remove this incentive, administration fees could be compared across three balance sizes in the test (e.g. $25,000, $50,000 and $75,000). These representative balances should be set in a way that aligns with the distribution of member account balances for each product segment, with the middle representative balance reflecting the median account balance. For example, the middle representative balance for MySuper products could remain at $50,000, noting that the current average account balance for MySuper products is about $65,000[15] and the median is likely to be less than the average. A higher middle representative balance may be justified in other segments, especially if the test is extended to retirement products (where average balances are $340,000[16]), as recommended below.

In addition, the performance test should be modified to adopt a common benchmark median administration fee for both MySuper and non-platform trustee-directed products. These are generally similar products with similar (or the same) levels of member services. Currently the median administration fees are similar for a $50,000 balance (0.26% for MySuper products in 2023, compared to 0.27% for non-platform TDPs). It is not clear why these products should be compared to different standards. Adopting a common benchmark fee would also simplify the test.

While lower fees are clearly advantageous to members, this should not come at the expense of poorer customer service, poorer complaints handling or super funds making more errors with members' accounts. Regulations can more directly target these objectives through mandatory customer service standards which reflect community expectations. This would create a level playing field on customer service outcomes, with the performance test playing a complementary role to incentivise the efficient delivery of customer service outcomes.

Recommendation 7: Amend the performance test to cover administration fees (relative to a benchmark) calculated at three representative balance levels. These representative balances should be set in a way that aligns with the distribution of member account balances for each product segment, with the middle representative balance reflecting the median member account balance.

Recommendation 8: Adopt a common benchmark median administration fee for MySuper and non-platform choice products in the performance test.

Recommendation 9: Introduce mandatory customer service standards for super funds which reflect community expectations.

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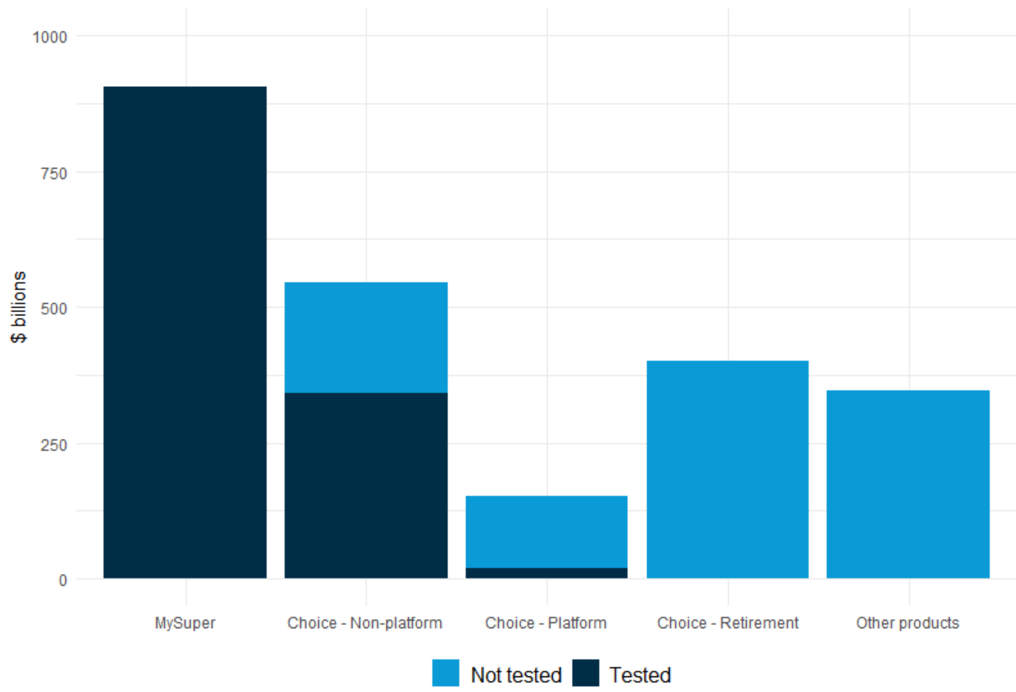
[15] APRA (2023), "Quarterly Superannuation Industry Publication", December 2023.
[16] Average balance for choice products in the retirement phase (excluding defined benefits), APRA (2023), "Quarterly Superannuation Industry Publication", December 2023.

Coverage of the test

Only 59% of assets and 81% of member accounts in APRA-regulated funds are currently subject to performance testing (Chart 2). This includes a significant number of members and assets in the retirement phase. Performance testing should be expanded to cover as much of the compulsory super system as possible.

Chart 2: Current performance test coverage of APRA-regulated funds (assets)[17]



[17] APRA (2023), "Quarterly Superannuation Industry Publication", June 2023, and APRA (2023), "The 2023 annual superannuation performance test outcomes".

Retirement products

Superannuation balances are typically largest at the point of retirement. According to Super Consumers Australia modelling, a person with a typical $200,000 balance at age 67 would have received $55,374 less (or 17% less) in investment returns across retirement if they were in one of the worst performing 'balanced' investment options versus one of the best performers.[18]

Many retirees will struggle to rebuild any losses they suffer from persistent underperformance, especially if they are unable to continue working. Those who are in an underperforming product have limited ability to assess their underperformance, because unlike the accumulation phase, they will not be notified of the underperformance, nor will it appear on a comparison tool. In addition, it has been estimated that the typical retiree will pay more in fees during retirement than during the entire accumulation phase.[19]

The existing performance test can be extended to account-based pensions and transition to retirement products straight away, as we explained in our recent submission to Treasury's consultation on superannuation in retirement.[20] This would have the advantages of:

- **Applying an appropriate test to retirement products** which are structurally similar to most accumulation products. Many retirement products have the same investment strategy as funds' accumulation phase choice options.
- **Closing the current regulatory 'loophole'** where an accumulation product becomes closed to new members because it fails the performance test, but an essentially identical retirement product continues to be offered to members–and at a time when their balances are at a maximum, meaning underperformance can have a significant impact on their lives in retirement.
- **Automatically taking account of common characteristics of retirement products**, including a more conservative asset allocation than accumulation products and the need to pay a regular income. The existing performance test already does this by tailoring the benchmark to each product's asset allocation, and by using cashflow-adjusted measures of investment returns.

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[18] This is the difference between net investment returns of 8.3% a year and 9.0% a year, based on the first and third quartile performance of pension products with a 60-80% growth allocation over 15 years to December 2023. Returns data from Chant West, sourced from Super Guide (2023), [Pension fund rankings: Growth category (61–80%)](). Modelling assumes a balance at retirement equal to the median balance of $200,000 for a 65-74 year old in 2019-20 based on ABS Survey of Income and Housing data. Retirement is modelled as from age 67 to 92, with drawdown at the minimum legislated rate and an annual administration fee of $74, consistent with Moneysmart default assumptions. Figures are in today's dollars, with inflation of 2.5% a year netted off returns.
[19] Rainmaker Information (2022), Retirees pay more in superannuation fees.
[20] Super Consumers Australia (2024), "Superannuation in Retirement: Submission by Super Consumers Australia", Available: https://superconsumers.com.au/wp-content/uploads/2024/02/SCA-submission-Superannuation-in-Retirement.pdf

The fact that some retirement products offer features such as longevity protection or guaranteed returns is no reason to delay extending the performance test to account-based pensions. As a subsequent and separate step, Treasury should establish a process for applying performance testing to other types of retirement products, including those that offer longevity production (such as annuities). It may be necessary to assess these products against several metrics, including both quantitative and qualitative measures.

Recommendation 10: Extend the existing performance test to account-based pensions and transition to retirement products from 1 July 2024.

Recommendation 11: Establish a process for designing an appropriately adapted performance test for retirement products that are not account-based pensions, to ensure there is a minimum standard that all products must meet. This should be done within 2 years.

Externally managed choice products

Multi-sector choice products for which the trustee does not set the investment strategy or manage the investments are currently exempted from the performance test because they are not deemed to be ‘trustee-directed’ products (unless the investment manager is a related party of the trustee). This is allowing many super funds to evade accountability for the products they offer their members. For example, 22% of the $460 billion in assets invested in multi-sector choice accumulation products in June 2023 were not subject to the performance test.[21] Many of the untested products are likely to be externally managed.

The status quo also gives rise to the perverse situation where a super fund is required to close an investment option to new members because the option is managed by a related party (e.g. an investment management company) and it has failed the performance test two years in a row. However, the same option can still be offered by other super funds and is exempted from performance testing, even though it has demonstrably underperformed.

Members who have invested in an externally managed product have as much right to be protected from underperformance as any other member. While funds may not be in a position to influence the way these products are invested, they decide which products they offer to members and are ultimately accountable for their performance. Members will continue to receive poor outcomes unless there is greater scrutiny on super funds for the performance of products they offer.

Recommendation 12: Extend the existing performance test to all externally managed multi-sector choice products from 1 July 2024.

[21] APRA (2023), “Quarterly Superannuation Industry Publication”, June 2023; APRA (2023), “Quarterly Superannuation Product Statistics”, June 2023; and APRA (2023), “The 2023 annual superannuation performance test outcomes”.

Single-sector and platform products

Single-sector choice products are also currently exempted from the performance test. About 28% of assets in choice accumulation products were invested in these products in June 2023. The superannuation and advice industries have argued that these products should not be subjected to performance testing as members (or their advisers) may have chosen products for specific reasons, such as risk management, in the construction of a portfolio.

This is a weak argument for allowing a significant portion of the compulsory superannuation system to evade transparency and accountability. Absent any clear and compelling evidence that it is impossible to construct a portfolio using only products that would pass a performance test, consideration should be given to extending the performance test to single-sector choice products.

In addition, APRA should be required to publish data on the performance of these products and how this performance compares to the relevant indices in the performance test. This would be similar to the metrics APRA has previously published for trustee-directed products in the choice heatmap.

Recommendation 13: Consider extending the performance test to single-sector choice products, unless there is clear and compelling evidence that it would be impossible for a member to construct an appropriate investment portfolio using only products that have passed a performance test.

Recommendation 14: Require APRA to publish data on the investment performance of single-sector choice products, including performance relative to the relevant indices in the performance test.

Disclosure of member-level performance

Currently, many choice members are failing to be protected from underperformance, especially those invested in products that are exempt from the performance test. It is often difficult for members to know how their investments are performing relative to appropriate benchmarks. As ASIC's recent review shows, super funds and financial advisers cannot be trusted to take responsibility for underperforming choice products.[22]

At a minimum, super funds should be required to give choice members greater transparency about their investment performance across their investments by disclosing their overall performance at the member account (i.e. portfolio) level relative to the composite benchmark used to assess net investment returns in the performance test. This requirement should apply to all choice members, especially those invested in platforms, single-sector products and direct assets.

[22] ASIC (2024), "REP 779 Superannuation choice products: What focus is there on performance?"

We understand that this type of disclosure is a common feature already built into many platforms so would require little additional cost for platform providers to implement. This would give members in these products a solid basis on which to judge the performance of their super fund and financial adviser. Where a member's investment performance falls below the benchmark, their fund should be required to send a prescribed disclosure, similar to the current performance test fail letters.

Super funds should also be required to report information to APRA and ASIC about the number of member accounts that perform above and below the benchmark, and the products they are invested in. This data should also be included in APRA's fund-level data publications. The information would better assist the regulators to identify funds with systemic performance problems, especially in the platform segment. It may also assist ASIC to determine whether a financial adviser has acted in a client's best interests in advising the take up of a platform or on the investment mix within it.

Recommendation 15: Require super funds to prominently disclose performance information to all choice members. This information should compare investment performance at the member account level to the benchmark used in the performance test. Funds should be required to send prescribed communications to each member whose performance falls below this benchmark.

Recommendation 16: Require funds to report information to APRA and ASIC about the number of member accounts that perform above and below the benchmark used in the performance test, and the products they are invested in.

Consequences of failure

Super funds should have to earn the 'right to remain' in our compulsory super system. The performance test must give funds strong incentives to improve products and, where they can't, to ensure members' interests are looked after by helping move them to better products. The consequences of failing the performance test should reinforce this by setting clear expectations for what should happen if a fund is unable or willing to improve a product's performance.

Currently, one of the main consequences of failing the performance test has been the reputational impact of funds being publicly named and shamed. For MySuper products, this has been effective at encouraging poor performing funds to exit the industry or to merge (in conjunction with supervisory pressure from APRA). For example, of the 13 MySuper products that failed the test in 2021, only four failed again the following year and were compelled to close to new members. By that time, the funds responsible for three of these four products had already announced or commenced mergers.[23]

[23] Australian Catholic Superannuation and Retirement Fund, EISS Pool A and BT Retirement Wrap.

To date, we have not seen the same reaction by funds with choice products that failed the 2023 performance test. Many of these products appear to remain in the system, holding significant amounts of money. It is likely that some of these products will fail the test again in 2024. Those that are still open will be required to close to new members, although many of the products appear to be legacy products that are already closed to new members – meaning that a second fail will have almost no consequences. For example, 87% of the products that underperformed a comparable metric to the performance test benchmark by 0.50% or more in APRA's Choice Heatmap were closed to new members.[24]

Limitations of disclosure

Super Consumers Australia fully supports members being told clearly, in a prescribed form, when products they have invested in have failed the performance test.

However, there are a number of deficiencies in the prescribed fail letter that funds must send to members who hold products that fail the performance test, which Super Consumers Australia has previously raised with Treasury.[25] These include:

- The letter is confusing and does not give members a clear sense of what action they need to take. It has also never been consumer tested.
- Funds are still permitted to include superfluous information in their fail letters, alongside the prescribed notification text. Both ASIC and Super Consumers Australia have found examples of fail letters that are unbalanced and undermine the fact that the product failed the test.[26] Funds have been allowed to obfuscate the true purpose and clarity of the notification, potentially leading to lower levels of switching. This oversight allows funds to distract from the true purpose of the failure notification, and confuse members with unnecessary and biased information surrounding the failed product.
- The YourSuper comparison tool that the standard letter directs members to does not include choice products.

[24] This 2022 Choice Heatmap metric is calculated in the same way as the investment component of the performance test. Data source: APRA (2023), "Choice Heatmap".
[25] For more detail, see our previous submissions, "Your Future, Your Super Review: Submission by Super Consumers Australia", https://superconsumers.com.au/wp-content/uploads/2023/12/YourFutureYourSuperReview_SubmissionbySuperConsumersAustralia.pdf (October 2022) and "Superannuation Performance Test Regulations 2023" submission, https://superconsumers.com.au/wp-content/uploads/2023/12/SuperConsumersAustraliaPerformanceTestRegulations2023submission2.pdf (May 2023).
[26] ASIC 2022, Review of trustee communications about the MySuper performance test, https://download.asic.gov.au/media/k1chrsc4/rep729-published-24-june-2022.pdf and Super Consumers Australia 2022, Are our funds being honest? A fact check on underperforming super fund communications, https://www.superconsumers.com.au/are-our-funds-being-honest-a-fact-check-on-underperforming-superfund-communications

We are also concerned that the current performance test puts too much emphasis on members taking action themselves to move to a better fund or product. While the YourSuper comparison tool is a welcome development to help them do this, in reality, many members will not understand why they need to switch or how to do it. For example, APRA reported that 7% of members in underperforming funds closed their accounts within two months of the performance test results being released in 2021. As Treasury's consultation paper notes, the number of member accounts in products that failed the test fell by only about 10% in the five months after each test.

The effectiveness of the fail letters is further undermined because:

- Many funds do not have up-to-date contact details for their members, so some members may never receive underperformance notifications.
- Many people–almost half of members–do not read the communications their super fund sends them.[27] Many are also unlikely to be regular readers of financial news in which underperforming funds might be named.
- Where members do read the notification, they may not understand it, or know how to take action. For example, 11% of people in our nationally representative survey said they have not changed their super fund because it was too hard, and another 11% said they hadn't changed because it was too hard to find a good super fund.[28]

Informing people about underperforming products through additional channels, including fund websites and MyGov messages, would help to reach more members in these products. Improving the YourSuper comparison tool and broadening its coverage to include choice products would also help to make it easier for members in underperformance products to switch.

Recommendation 17: Improve the prescribed letters sent to members of products that fail the performance test by undertaking targeted consumer testing (informed by behavioural insights) and explicitly prohibiting funds from including any communications in their fail letters other than the prescribed text.

Recommendation 18: Require funds with products that fail the performance test to display a prominent notice on their website homepage until the product has passed the test, or is no longer offered.

Recommendation 19: Notify people in underperforming products, via a message in their MyGov inbox, that their product has failed the performance test.

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[27] Based on 1,181 responses in October and November 2022. Super Consumers Australia (2023), "Super Consumer Pulse Wave 0: Results from our pilot national consumer survey", https://superconsumers.com.au/research/super-consumer-pulse-wave-0-results-from-our-pilot-national-consumer-survey/

[28] When asked they haven't changed their super fund in the past 2 years. Based on 1,005 responses in October and November 2022. Super Consumers Australia (2023), "Super Consumer Pulse Wave 0: Results from our pilot national consumer survey", https://superconsumers.com.au/research/super-consumer-pulse-wave-0-results-from-our-pilot-national-consumer-survey/

Recommendation 20: Work in consultation with consumer groups to extend the ATO YourSuper Comparison Tool's product coverage to choice products, and ensure the tool complies with the Australian Government's digital service standards.

Disclosure-based approaches that put the onus on the consumer to find a better product are, on their own, poor consumer protections in financial services.[29] In a compulsory super system, members should be able to rely on their fund and regulators to take action to protect them from underperformance that could leave them materially worse off during retirement. This means that the consequences of failing the test—especially a second fail—ensure that members' interests are protected.

Consequences of repeat test failures

Currently, when a product fails the performance test two years in a row, the fund is prohibited from accepting new members into the product. However, this ban on distribution is more a punishment for the fund than a protection for members. The trustee is not required to move existing members to a better product. The members are at risk of languishing in a closed product with their retirement balance continuing to be eroded by poor performance and/or high fees. For example, APRA has found that 67% of closed choice investment options fell below the benchmarks in its Choice Heatmap, compared to 39% of open choice investment options and 21% of MySuper products.[30] The closed products also charged higher fees.

This problem will only grow over time as the number of closed products in the super system continues to increase. Stronger consequences are needed if the performance test is to be enduring.

Trustees are obliged to act in the best financial interest of members. However, in practice, most have done very little to get members out of poor performing products. This remains a major problem in the choice sector. In its recent review, ASIC found that some trustees and financial advisers were failing to protect members from underperforming choice products, observing that some trustees over-relied on the fact that members were advised and some advisers over-relied on products being included in trustees' investment menus.[31] The Productivity Commission previously found that some trustees were effectively 'outsourcing' their best interests duty for members that are using platforms and wrap accounts to financial advisers and product providers.[32] There is also likely to be a considerable number of superannuation members who invested in choice and platform products on an adviser's recommendation, but the relationship with their adviser has since ended.

[29] For example, see ASIC (2019), "REP 632 Disclosure: Why it shouldn't be the default".
[30] APRA (2023), "APRA Choice Heatmap", Insights Paper, p. 10.
[31] ASIC (2024), "REP 779 Superannuation choice products: What focus is there on performance?", p. 7.
[32] Productivity Commission (2018), "Superannuation: Assessing Efficiency and Competitiveness", Inquiry Report No. 91, p. 61.

It is unrealistic to expect trustees (or advisers) to proactively move members out of underperforming choice products in the absence of a clear requirement to do so for products that repeatedly fail the performance test. At present, this is a key missing component of the performance test. It is a particular concern for products that have already been closed to new members prior to failing the performance test, meaning a second fail effectively has no consequence for either the trustee or existing members.

Government should legislate stronger consequences for products that repeatedly fail the performance test. The emphasis should be on protecting the retirement balances of existing members. This could be done in line with the Productivity Commission's original recommendation for the performance test, that trustees be obliged to transfer existing members to a different product or another fund where trustees are unable to improve the product's performance.[33] This would be closely overseen by APRA, with APRA given powers to step in if necessary. This could be done by further extending APRA's already enhanced resolution powers in superannuation.

To protect members' interests, the products members are transferred to should have a similar investment strategy to the failed product and should have passed the annual performance test (i.e. it cannot be a newly created and untested product, or a product that has ever failed the performance test). Members should be given advance notice and the ability to 'opt out' to move their savings elsewhere if they do not wish to be transferred to the replacement product.

A similar process has been used previously in the transfer of Accrued Default Amounts to MySuper products when the MySuper regime was introduced. However, this was not always implemented in members' interests. To avoid repeating the mistakes of the past:

- Funds should be given a maximum of 12 months to find a more appropriate product, so that reluctant funds do not take years to transfer members. This timeframe was achievable for many of the funds who exited the market via a merger after the first round of performance test failures.
- APRA should be given strong powers to veto an inappropriate choice and to direct unwilling trustees, to prevent trustees from moving members to other poor products,
- The member communications and opt-out process should be prescribed, to minimise the risk of funds persuading members to choose an inappropriate alternative product.

To the extent that such a transfer would leave some members worse off as a result of triggering capital gains tax or ending grandfathered social security arrangements, the government could consider offering (narrow) taxation relief for the purposes of facilitating a transfer out of a product that has failed the performance test.

Recommendation 21: Legislate to oblige trustees of products that repeatedly fail the performance test to transfer existing members to a different product that has passed the performance test (including in a

[33] Productivity Commission (2018), "Superannuation: Assessing Efficiency and Competitiveness", Inquiry Report No. 91, p. 590.

different fund, if necessary). This should be done within 12 months. APRA should be empowered to intervene by directing a transfer of members to a better fund if the trustee is unable or unwilling to find an appropriate product. Members should be given the option to transfer their savings elsewhere if they do not wish to be transferred to the replacement product.

Complement the test with improved default allocation

There is a risk that, without other measures to drive healthy competition across the compulsory superannuation system, super funds will become overly focused on clearing the low bar of the performance test. It is not practical or desirable to expect the performance test to do all the heavy lifting in driving strong long-term member outcomes. The strength of the test is that it sets a 'bright line' which focuses funds' attention on adding to the net returns that the market would deliver on its own. The test should be left to achieve what it is effective at: identifying and removing poor performers, while complementary measures outside of the test should be deployed to drive broader performance goals. There is a risk that attempting to use the test to solve all problems in the industry will water down the clear impact it has had on weeding out underperformance.

As the Productivity Commission stated, lopping off the tail of persistent underperformers will produce better outcomes, but on its own is unlikely to produce the best outcomes. In the long term, there should be very few products failing the performance test each year, as poor performers will have exited the industry, and the test will help ensure the tail of underperformers does not regrow. More will be needed to drive healthy competition and ensure there are incentives for super funds to continually improve. The performance test is, and was always meant to be, the first step towards this.

The Productivity Commission recommended that improvements to the efficiency of the super system should focus on improving member choice and the default fund allocation process, and that this should be done through a universal online choice form and a 'best in show' list for people who do not select a fund. This model was designed to improve long-term member outcomes by nudging people into or allocating them to the best products in the market. This would stimulate competition between funds to get on the shortlist and drive healthy competition for members. We encourage Treasury to consider how reform to the default allocation model and continued improvement of the YourSuper comparison tool can improve competition and drive positive member outcomes to complement the performance test.

Recommendation 22: Consider how reforms to the default allocation model (including a 'best in show' list) and continued improvements to the YourSuper comparison tool can help to drive healthy competition that lifts outcomes for all superannuation members.