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Your Future, Your Super

New ways to judge the past

August 2021

The **Your Future, Your Super** (YFYS) legislation follows **Protecting Your Superannuation** (PYS, 2018) and **Putting Members' Interests First** (PMIF, 2019). All are consequences of the Productivity Commission's (PC) review of superannuation, together with changes made as a result of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Simultaneously, the government conducted its Retirement Income Review and publicised its report late in 2020. The government's response to this had been expected in the May Budget, but it was deferred to await the Intergenerational Report (IGR5), which was released on 28 June 2021.

We should now expect an update on pending legislation around retirement incomes.

Meanwhile, the YFYS legislation will have some profound implications for the superannuation industry.

The work of the Productivity Commission

The PC looked at the superannuation system in 2012 before the introduction of MySuper products from 2014. In its report into Default Superannuation Funds in Modern Awards[1], it concluded that the system of determining default funds through the existing industrial award system was flawed. It recommended the Australian Prudential Regulation Authority (APRA) adopt a merit-based system for determining default funds together with:

"a set of non-prescriptive factors to be considered as a second stage 'quality filter' when selecting default products for modern awards. The factors relate to investment objectives and performance (as primary factors); fees and costs; governance practices (particularly mechanisms in place to deal with conflicts of interest); insurance; intra-fund advice; and administrative efficiency".

In February 2016, the PC was appointed by then Treasurer Scott Morrison to undertake a three-year review of the superannuation system. The scope of the study was to develop criteria to assess the efficiency of the superannuation system and, from this, to develop alternative models for allocating default fund members to products.

The work was split into three stages:

- **Stage 1** – Following the release of an issues paper to help industry participants to prepare submissions, the PC consulted with interested parties and in November 2016 produced a draft report.
- **Stage 2** – This looked at alternative default models for allocating new members to products. The final report was issued in August 2017.
- **Stage 3** – Using the criteria from Stage 1, the PC undertook a review of the competitiveness and efficiency of the Australian superannuation system. The final report was issued in January 2019.

While the process was thorough and the research was comprehensive, many in the superannuation industry disagreed with the proposed changes. The final report was disappointing as it failed to adjust its recommendations following valid industry criticism of a number of its suggestions in its draft reports[2].

It concluded by recommending yet another inquiry — the impact of superannuation on national savings in funding retirement income — to be held before the government continued with scheduled increases in the superannuation guarantee (SG) from 2021. The government used this recommendation to establish the Retirement Income Review, which reported back in July 2020.

[1] https://www.pc.gov.au/inquiries/completed/default-super/report 12 October 2012

[2] https://www.ricewarner.com/wp-content/uploads/2019/01/Insight_-Productivity-Commission-Final-Report-A.pdf

The PC recommended several changes to the superannuation system including:

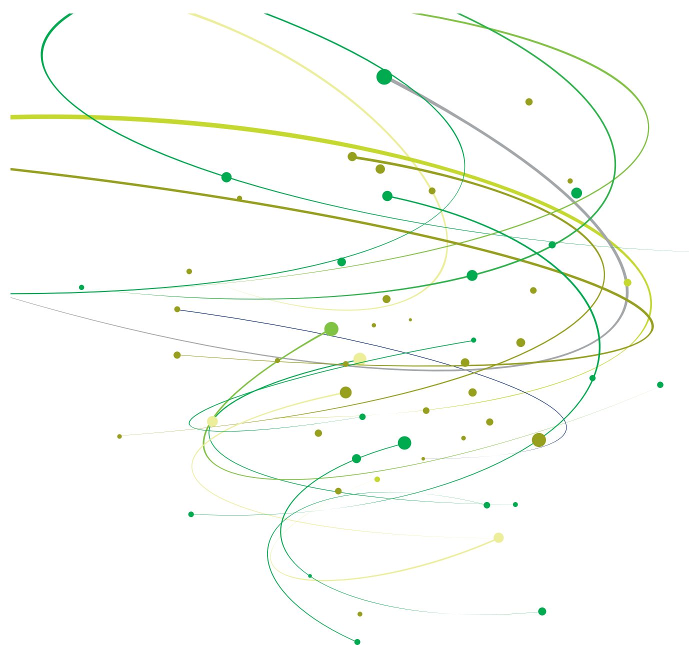
- removing unnecessary multiple accounts
- removing poorly targeted life insurance
- developing good retirement products and strategies
- eliminating funds with persistently poor investment returns
- addressing those funds with fees that are excessive relative to the services provided
- addressing the remaining trail commissions on superannuation accounts.

The PC concluded that the current superannuation system was inefficient, and it suggested changes to fix this. The most controversial was that there should be 10 funds ('Best in Show') authorised to receive default (SG) contributions. The concept was considered by many experts and commentators to be flawed and has largely fallen by the wayside, but two key themes have emerged from it:

1. Separating the default superannuation system from industrial awards.
2. Further reducing the number of funds eligible to receive default contributions.

Another controversial suggestion was to measure investment performance over rolling 8-year periods, without any explanation as to why this was preferred to the traditional industry (and global) approach of using 7 or 10 years as a long-term measurement period. The PC also recommended measuring performance against a benchmark of indexed funds for each asset class. Funds with results falling short of the benchmark by more than 0.5% a year (after fees) would be given 12 months to fix their performance (which is highly unlikely in most situations, without taking on additional risk and/or some element of luck) or they would be prevented from accepting new members.

The PC also recommended a sweeping review of life insurance within superannuation and a separate review of retirement incomes. The former is still unresolved, but the latter resulted in the Retirement Income Review.



Your Future, Your Super

In the October 2020 Budget, the government released its package of superannuation reforms called **Your Future, Your Super**. Following a brief consultation period, Treasury released its Exposure Draft Regulations and Explanatory Statement in December for public consultation.

Following some heated Parliamentary debate and much industry opposition, the legislation was passed in June 2021.

The key components of the legislation are:

- To 'staple' new members to a fund for life (or until they exercise choice).
- To measure the investment performance of MySuper products against peers and show this on a new Australian Taxation Office (ATO) comparison website from 1 July 2021. This will allow people entering the workforce to evaluate the performance of default products and make a choice.
- To measure the investment performance of default products initially and then, from July 2022, all other products where trustees select and control the asset allocation ('Trustee Directed Products'). APRA will measure this on a quarterly basis against a list of benchmark indices, weighted by funds' strategic assets allocations. Critically, this does not measure the impact on returns of the strategic asset allocation itself, even though this tends to be the most important driver of member outcomes.

  The measurement period will be eight years. However, the first period will be seven years (from the start of MySuper) and new funds will have to build a five-year history before being measured. Funds which are more than 50 basis points (0.5%) a year below the benchmark will be deemed to have under-performed, with severe consequences. The first measurement is at 1 July 2021, so members of underperforming funds will receive a notification by 1 October 2021.
- There are limits on trustee expenditure to ensure money spent by funds is in the best interest of members.

The final legislation did include some changes based on the consultation process. The key ones are:

- Stapling will now commence from 1 November 2021. This is a four-month delay to give more time to implement.
- There are new indices for unlisted property and infrastructure benchmarks. The original proposal would have used the same benchmarks for listed and unlisted investments in both categories.
- Discretion within the Regulations for APRA to lift the prohibition to take on new members in certain circumstances.

Stapling members to a single fund

The new stapling rules will eliminate unintended duplicate accounts by connecting all future employment-related contributions to a member's existing account. The new structure will reduce the number of accounts, thereby cutting overall fees and insurance premiums.

Impact of stapling on funds

Initially, a lot of effort by regulators will be directed to convincing smaller funds to merge to achieve enhanced scale for both funds. This will be a defensive position, to grow quickly before the impact of the new legislation sets in. Some small funds lack scale and anticipate a decline in new members, leading to stagnation. Many will give in and join large funds. Indeed, the merger trend is continuing, with Club Plus, Intrust, LUCRF and Statewide recently announcing merger intentions.

The automatic flow of new members from industrial awards will cease. This will make it even more important for funds to build strong consumer brands, as several large funds have been doing for some time. Where an existing employer-sponsor is supportive, a fund could arrange presentations for new employees to show them the benefits of their fund. This will be especially relevant where an employer is doing at least one of the following: subsidising fees, subsidising insurance arrangements or using its buying power to negotiate a discount. Growth teams will also need to market directly to members to attract new members to join the fund through choice. These activities will add to fund marketing costs.

Growth teams will seek to attract new entrants to superannuation – the young and migrants. This will require positioning around these groups. For example, providing education about superannuation in schools and universities.

On the other hand, superannuation funds will have higher levels of retention as most members will stay with them when changing jobs. This should help them build higher average account balances and allow them to better engage with their membership. We expect funds will concentrate on retaining those members with large balances.

Some funds might exit the default market and specialise in choice members, SMSFs or providing retirement benefits for families.

Impact of stapling on members

Existing members of superannuation funds will have stability as they change jobs in future. If they take a second job, their SG contributions will flow into the same fund. Stapling will lead to larger account balances (partly from lower fees and premiums, in addition to having only one account).

Funds have an opportunity to better engage with these members. If they do not, they run the risk that members will choose a different fund and leave.

Impact of stapling on employers

The biggest change is to the traditional group arrangements. Big employers have been able to obtain discounted fees and tailored insurance benefits. However, these benefits rely on the bulk of employees joining the corporate sub-plan either in a master trust or industry fund.

Employers could continue to show the benefits of their arrangements to new employees, but they will be reluctant to provide financial advice, so this will limit their communications and its effectiveness. In some circumstances, this may be taken up by their default industry fund or master trust. If employees are already stapled to another fund, there will need to be a sound incentive for the member to convert. In any event, how many employers will want to continue to be actively involved in this complex arena?

It will be easier for employers to convert those who are joining the workforce for the first time. Some will simply sign up for the employer's fund; others might use the ATO website to seek out the best performing fund.

There continues to be concerns that the benefits of a group employer arrangement currently provided by many large employers will become less widely available. This could lead to reduced insurance cover and even lower contributions, as many of these employers will revert to a simple SG structure and no longer provide enhanced benefits to their employees.

The legislation increases the shift from superannuation being an employee benefit towards being an individual obligation. As a result, the few remaining stand-alone corporate funds will be considering their future as they seek to attain scale and sustainability.

Impact of an employer changing its default fund

The draft legislation does not seem to consider how to treat those employees that are existing default members of a fund where the employer is seeking to change its default fund, but the employees are not changing jobs.

Under stapling, there is some confusion and conjecture as to how an employer can best effect a change to the direction of default contributions on behalf of those employees that do not choose their own superannuation fund. Moving members' account balances from one fund to another is undertaken either using a 'Successor Fund' or a 'member consent' transfer. If the Successor Fund provisions of the SIS Act are being utilised, then this will capture existing account balances as well as future contributions, and it is not necessary to obtain the consent of individual members to transfer to the new arrangements. However, the vast majority of transfers are now undertaken using the member consent basis.

Up until now, the direction of the default SG contribution has been up to the employer to determine. Some providers are suggesting that this remains the prerogative of the employer and that it can be changed at the employer's discretion (for default contributions only) with employees retaining the ability to opt-out of this in favour of either remaining in the existing default or otherwise effecting an alternative choice of fund. The transfer of the account balance would still be required to be undertaken on a member consent basis. Other providers are suggesting that they will endeavour to encourage all employees to join the new default arrangement on an opt-in basis for both the existing account balance and for future contributions.

It is not clear yet whether opt-out will be permissible and we will need to wait for the final regulations to clarify the situation.

Addressing underperformance

Performance will be measured by taking a fund's strategic asset allocation and calculating a benchmark performance using a list of relevant asset class indices. The list has been updated following industry consultation and each index also has a default fee and tax structure. The actual asset allocation is not being measured, so a highly conservative fund could pass but give mediocre returns; conversely, a fund focusing on growth assets but performing below benchmarks within these assets could fail even if it outperforms a mediocre conservative fund.

The index fees are low and a fund will fail the performance test if it is worse than 0.5% a year behind the index (after fees and tax). That means that active managers (including in-house teams) have a clear hurdle to overcome. Australian equity managers can use franking credits to get a tax premium over the index; fixed interest managers can use duration and credit risk to outperform the bond index. Very large superannuation funds are likely to continue to seek alpha from unlisted assets, especially in areas where size is an advantage in gaining access to private market opportunities.

The major criticism of the legislation is that it is retrospective and measures historic performance prior to its announcement. Some of the underperforming funds have restructured and might well give good value in future – but they are bound by their historical execution of their investment strategy, even if the asset allocations which are not measured in YFYS have been beneficial to members. All of this is despite it being a requirement for all funds to warn consumers that past performance is not a guide to future performance.

Initially, the process for dealing with underperforming funds was too prescriptive and it left no room for any discretion by APRA even if previous issues have been resolved. Given the initial calculations will be based on a period of performance pre-dating the legislation, it is retrospective legislation giving little or no opportunity for funds to address any problems.

In its submission to Treasury, Rice Warner suggested that APRA should be given some discretion not to apply 9AB.19 of the Regulations in some circumstances. It should measure the underperformance and then review whether the fund has taken meaningful steps to address any past issues. If they are not satisfied, the process can continue as set out in the Regulations. However, if funds have reformed in some way, APRA can agree a pathway to include new investment processes and costs. We note that members are not disadvantaged by staying in an historically underperforming fund if the (expected) future investment processes and current costs are appropriate. We are pleased that this change was made to the final legislation and APRA now has discretion to defer the penalty.

If funds fail the performance test, they must notify members. The prescribed letter to be sent to members is likely to be construed as incendiary. Some members might be alarmed and seek another fund (perhaps using the ATO website). Many will then make their choice based on past performance and ignore current investment processes and risks, and other benefits such as life insurance.

Underperforming in two consecutive years means the fund cannot accept new default members. This would also unsettle existing members and could potentially lead to large outflows.

Many funds will be aware that they cannot reverse their historical underperformance in one year, so they already know that they will be writing to members in 15 months. Some funds might even take unusual steps to protect their membership base.

Impact of under-performance measurement

In response to the new under-performance test, some funds may decide to close their existing MySuper product(s) and create a new product with different characteristics. For example, they could change the underlying investment structure – if they have a lifecycle strategy, it could be replaced with a single investment option. The fund could migrate the members into the new product, using the message that it will provide better future investment performance than the current product.

This approach will give many funds an opportunity to reset and not be measured against past legacy performance. While the legislation seeks to protect against any gaming of the rules, it would be difficult for the regulator not to register a genuine well-structured new product, particularly as the performance of lifecycle products is measured on average across the whole membership rather than tranche by tranche.

Another option might be to develop a low cost index MySuper product to protect default members and steer the fund's marketing strategy into building a choice structure in which the asset allocation is self-selected by the members (potentially with the assistance of an adviser) rather than being trustee-directed. This would protect the trustees but arguably weaken the likely outcome for many members.

We note that APRA will still use its Heatmap to measure funds in several areas. Fear of failure, in part because of the severity of the associated consequences, is likely to lead to a narrower range of risks being adopted by default fund structures. This is not necessarily bad if it eliminates all underperforming funds, but it might lead to more activity in choice markets where members have less protection. In particular, there could be a shift to self-managed super funds (SMSFs) where the performance is not measured by the regulator, and the liabilities reside more directly with the members.

In this environment, successful strategies for larger funds will likely include insourcing investment teams to drive down fees and investing more directly in private market assets such as taking companies off-market, using private equity and investing in start-ups. Smaller funds will generally not have the resources to utilise a number of these strategies, so will need to adopt alternative approaches where they have a competitive advantage to ensure that they do not fall behind.

ATO website

To help members select a default fund, the ATO will maintain a **YourSuper** online comparison tool. This is a simple ranking based on the absolute performance of funds, but the regulations provide for APRA to provide data on other metrics.

The ATO site will not be subject to the onerous rules for comparison sites in the private sector.

Various improvements have been suggested, such as:

- The list being grouped randomly in blocks of five funds to negate the presentation of a fund appearing at the top by a very small margin.
- The period of measurement being changed to show results over both 7 years and 10 years. These are the periods commonly used by the global investment community for long-term measurement. It does not make sense to pick a new period without any evidence to justify it. We note the PC (whose advice the government relied upon to select its measure) did not present a considered case for selecting an eight-year period.
- Development and inclusion of appropriate measure(s) of risk.
- Inclusion of the investment target for members (for example, CPI+ 4% over rolling 10-year periods) for reference alongside the historical absolute performance of the fund.
- The size of assets held in MySuper being shown as many members would consider a large fund to be safer.

We also note that the ATO website will measure past performance and makes no allowance for superannuation funds that have changed their investment processes, structures or fees, such that the historical measures are no longer valid for comparison purposes.

Impact of website

There continues to be concerns that employees seeking a fund for the first time will simply select the leading fund from the ATO list, believing that it is endorsed by government. In fact, the list is based on rigid assumptions and reflects past performance and fee scales. This is ironic given ASIC requires all financial products to include a statement that past performance is no guide to future performance. Further its Regulatory Guide No 53 encourages all promoters (including superannuation funds) to **not give disproportionate prominence to past performance in promotions for a product or service**.

A tool based simply on past performance without any explanation of asset allocation or relative investment risks is a crude tool and is, in effect, a pseudo 'Best in Show' list updated each quarter. We can expect naïve new entrants to superannuation to select the fund at the top of the list (or a well-known brand name close to the top). This will give a temporary advantage to those funds that are 'Top of the Pops' in any particular quarter.

Members' best financial interests

This legislation requires trustees to consider all their activities and to confirm that they contribute to better financial outcomes for members. Funds will need to provide evidence to justify all expenditure.

There has been speculation that this legislation is aimed at industry fund expenditure in areas such as advertising and sponsorship. However, given the need for funds to build their own distinct brands to attract new members, it is likely that most current activities will pass this test if the expenditure is not excessive. Indeed, with the YFYS changes imposing an even more competitive framework on the superannuation market, the focus of funds will increasingly shift from employers to direct-to-member activities. This will likely result in more spending on marketing and promotional activities to attract new members. In this evolving environment, any unreasonable restrictions imposed on any fund's advertising and promotional activities could seriously impede the ability of some market participants to compete.

There are also cases of some funds paying fees to third parties such as unions or industry associations to provide various services. These services will need to be justified with a business case.

Life insurance

A number of recent legislative changes have affected the provision of life insurance within superannuation, including PMIF, PYS and now YFYS. The group insurers and superannuation funds are grappling with these changes and we will prepare a separate newsletter shortly on the implications for group insurance.

Summary

We agree with the government's intention to eliminate unintentional multiple accounts and underperforming funds.

However, we are concerned that the techniques adopted could have some undesirable consequences, particularly in the next year or so as some funds are unfairly penalised for past performance relative to a measure that fails to reflect the key role of strategic asset allocation decisions in actual outcomes. We are disappointed that many of the PC's recommendations were accepted without question, even though many flaws were clearly identified by industry participants.

We note that MySuper funds will now be measured against four different criteria:

- The APRA Heatmap, which measures a number of services, and which will be extended to life insurance and retirement benefits
- The new APRA Performance measure, which will highlight those funds performing at least 0.5% a year worse than the legislated benchmarks over an eight-year period (or from five years for new funds)
- The ATO consumer website, which will only look at investment performance (net of investment and administration fees) over the last eight years
- The fund's own target for members (usually expressed as CPI + X% over 10 years).

While we support different measures, we are concerned about using one measure without appropriate explanatory supporting statements to help consumers. Nonetheless the YFYS legislation is now a reality, with profound implications for many aspects of funds' propositions and strategies.

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