Treasury Laws Amendment (Your Future, Your Super) Bill 2021

Executive Summary

HESTA welcomes the opportunity to make a submission to the Senate Economics Committee on the *Treasury Laws Amendment (Your Future, Your Super) Bill 2021* ('the Bill').

HESTA endorses the overall aspirations of the Bill; however, there are significant issues with the proposed design and implementation of the reforms that mean they do not address fundamental issues raised by the Financial Services Royal Commission or the Productivity Commission in relation to underperformance and governance.

HESTA has significant concerns regarding:

- The lack of a materiality threshold in the proposed best financial interests duty (BFID);
- BFID being 'blind' in relation to dividend payments to shareholders;
- The reversal of the onus of proof for BFID;
- Regulation making powers that can arbitrarily ban certain investments or payments "*regardless of whether the payment is considered to be in the best financial interests of the beneficiaries*"[1];
- The potential impacts of account stapling as currently designed and scheduled; and
- Significant burden for employers to administer stapling from 1 July 2021.

We also note that significant amounts of detail are being left to (as yet) unseen regulations that are purportedly scheduled for implementation and commencement on 1 July 2021. We do not believe this is consistent with good public policy development and (based on available material about what is likely to be in the regulations) we have concerns regarding:

- The effects of the proposed performance benchmarks on the investment strategies of individual funds and the wider economic implications that may follow;
- The (apparent) absence of administration fees in the performance benchmarks;[2]

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[1] *Treasury Laws Amendment (Your Future, Your Super) Bill 2021 - Explanatory Memorandum* – Para 3.27 – Page 38.
[2] We are not aware of any organisation or economist (outside of government) that has supported administration fees being excluded from the performance benchmarks.

The Senate Scrutiny of Bills Committee "*assesses bills against a set of accountability standards*" and "*operates on a non partisan, apolitical and consensual basis.*"[3] Given this framework and approach it is significant that the Committee has expressed numerous concerns about the Bill, particularly the number of issues being left to regulations.[4]

We note the Committee raises concerns across all three schedules of the Bill and consistently questions the explanations (or lack thereof) for why it is necessary to rely on delegated legislation to such a large degree.

For example:

> *1.28 The committee's view is that* ***significant matters, such as basic requirements about default arrangements for superannuation payments****, should be included in primary legislation unless a sound justification for the use of delegated legislation is provided. In this instance, the explanatory memorandum states that the regulation-making power is 'appropriate to ensure there is sufficient flexibility for the government to response quickly to evolving industry practices' and that it is anticipated that the regulations will contain significant technical detail.*
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> *1.29 While noting this explanation,* ***the committee has generally not accepted a desire for administrative flexibility to be a sufficient justification, of itself, for leaving significant matters to delegated legislation****. The committee notes that leaving even the basic requirements that must be satisfied for a fund to be a stapled fund to regulations provides the executive with a broad power to determine and modify matters in relation to these funds in delegated legislation.* ***It is unclear to the committee*** *why at least high-level guidance in relation to these matters, such as the requirement that the fund is an existing fund of the employee, cannot be provided on the face of the bill.*[5] (emphasis added).

And furthermore:

> *1.33 The committee has further* ***consistently*** *drawn attention to framework provisions, which contain only the broad principles of a legislative scheme and rely heavily on delegated legislation to determine the scope and operation of the scheme. The committee considers that such an approach* ***considerably limits the ability of Parliament to have appropriate oversight*** *over new legislative schemes. Consequently, the committee's view is that significant matters, such as the scope of the proposed scheme to require superannuation funds to undergo annual performance assessments, should be included in primary legislation unless a sound justification for the use of delegated legislation is provided.*[6] (emphasis added).

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[3] www.aph.gov.au/Parliamentary_Business/Committees/Senate/Scrutiny_of_Bills/Role_of_the_Committee
[4] Standing Committee for the Scrutiny of Bills – *Scrutiny Digest 4 of 2021* (pages 10-16).
[5] *Scrutiny Digest 4 of 2021* (page 11).
[6] *Scrutiny Digest 4 of 2021* (page 12).

At present the Bill creates a skeleton framework that does not include important aspects of these significant regulatory changes. In our view it is undesirable that:

- The Bill purports to implement stapling but does not include a definition of a stapled fund;
- The Bill aspires to deal with underperformance but does not include the proposed performance benchmarks; and
- The Bill creates a power to prohibit certain payments or investments but does not specify what they are.

Some measures are also inconsistent with those applied to other corporations or commercial entities in Australia, specifically:

- The power to prohibit certain payments or investments, and
- The reversal of the onus of proof.

HESTA submits that it would be inappropriate for the Bill to proceed in its current form along the proposed timelines.

We note and endorse the submissions of our representative bodies, particularly the Australian Institute of Superannuation Trustees (AIST) and Industry Super Australia (ISA).

Background

HESTA holds $60 billion of assets on behalf of 880,000 members in the health and community services sector, 80% of whom are women. The performance of those assets and our members' financial wellbeing can be materially impacted by even small changes to the retirement system. Our members rely on us to ensure that their retirement story is told, and their working life is considered in complex policy deliberations.

Our typical member is a 43-year-old female. She works in health or community services where she earns on average 15.9% less than her male counterpart doing the same job with the same skills[7]. She spends considerable time caring for others in an unpaid capacity which adds enormous economic benefit to the country. Because of all this, at 43, she has less than $30,000 in superannuation and will be financially penalised in retirement. The way in which HESTA can operate and invest matters to our members because they participate in a sophisticated system that doesn't yet adequately reflect their working lives.

[7] https://www.wgea.gov.au/data/wgea-research/australias-gender-equality-scorecard/health-care-and-social-assistance

Schedule 1—Single default account

HESTA

- Supports the need for measures to address multiple accounts;
- Believes there is a danger of members being stapled to under-performing funds;
- Advocates that members are not stapled to inappropriate accounts, especially in relation to the provision of insurance;
- Notes the potentially significant burden for employers to administer stapling from 1 July 2021.

We strongly believe that a better model for ensuring the non-proliferation of multiple accounts should be based on the automatic rollover of balances, whereby a member is "stapled" to their balance which is automatically rolled over into their new account when they join a new employer. This will require an ongoing role for the Fair Work Commission to ensure funds receiving money are appropriate for their industry. The submissions of ISA to this Committee and in many other forums clearly articulate how this more sophisticated model better aligns with the best interest of members.

Many of our members rely on the ancillary products we are obligated to supply – such as life and permanent incapacity insurance. Under the Government's proposed model of "stapling" a new workforce entrant who is stapled to a product while working in a relatively low-risk industry such as retail, but who later moves into a higher-risk industry such as nursing, will retain an insurance policy that is unlikely to cover them appropriately.

We strongly endorse the findings of the KPMG Report commissioned in 2019 examining how the use of technology could tackle underperformance and multiple accounts simultaneously.[8]

If the proposed version of stapling occurs before underperformance is significantly addressed then members in underperforming funds may be stapled to those funds, potentially for the balance of their working lives. Member protections and sequencing to address the poorest examples of underperformance prior to stapling is vital to avoid this type of member harm.

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[8] https://www.industrysuper.com/media/stapling-of-superannuation-accounts-an-independent-analysis-by-kpmg/

Currently there is no automated method for employers to ascertain a new employee's 'stapled' fund. Considerable time and effort will be required by the employer to search for the existing fund for each new employee that commences with them. This will be a difficult task regardless of the size of the business given that small business employers may have limited administrative support and big employers can have large volumes of new starters on a regular basis. This creates the potential for harmful impacts from system compliance. There is also no way an employer can determine if the fund they identify for their employee is a high performing fund or not.

The resources required and the risk of an initial manual system for employers is far greater than any benefits likely to occur from stapling during this time, especially before underperformance is addressed. Many large HESTA employers are already under considerable financial and administrative pressure due to being on the frontline of the COVID-19 pandemic.

Time spent developing a fully automated solution and addressing underperformance before commencing account stapling would be time well spent for employers, employees, and the economy.

Schedule 2—Addressing underperformance in superannuation

HESTA

- Recommends performance benchmarking be comprehensive irrespective of product or sector and stretch across all fee types.
- Believes legislation should be examined to understand what behavioural changes will result from proposed benchmarks.
- Advocates that the primary legislation should define the proposed performance metrics and not leave substantive issues to regulations.

Underperformance

In the absence of any further detail our understanding of the proposed performance benchmarks is based on the Treasury paper '*Your Future, Your Super Reforms to make your super work harder for you'* released in October 2020. We note that any regulations made under this Bill could adopt a different approach.

HESTA strongly support the policy intent to give greater transparency to beneficiaries and protect them from underperforming products. It is unclear why the Government would choose to use a metric to determine returns before administration fees have been deducted. To ensure greater transparency, performance should be assessed on Net Returns, ie net of investment AND administration fees.

The differences in the fee culture of retails funds and industry funds has been well documented by the Productivity Commission, the Royal Commission and recently by APRA in discussion of the 2020 heat maps.[9] We encourage the Government to consider the analysis of the Heatmap by ISA and referenced in their December 2020 submission on the draft legislation.[10] If the aim of the reforms is transparency and protection, it is crucial that all fee types be considered so that the end result is reflective of what members will actually receive in their accounts.

Further, we encourage a more nuanced conversation about systemic underperformance rather than the blunt measures proposed in the exposure draft. It may be that from time to time, strong funds will underperform at the margins of the proposed measure. The

[9] Helen Rowell, Speech to ASFA Briefing, APRA Heatmaps 2020.
[10] https://treasury.gov.au/consultation/c2020-124304

proposed measure should consider systematic underperformance which might be evidenced over a longer period of time or a more material difference from the benchmark.

The time period proposed for the assessment is also not reflective of contemporary understanding of market cycles. Investment performance should be considered over a longer time period of 10 years.

Our concerns about the proposed benchmarks within the performance test are that funds may not be able to invest with only a focus on optimising the risk/return outcome for members over the long term.

We share the concerns raised by other industry participants and stakeholders, primarily:

- the limited capacity to consider the different risk characteristics of investments and the appropriate management of risk, including use of defensive and growth options, to match members' needs across their lifetimes;
- the incentive this will likely create for trustees to focus on the management of risk and returns relative to the proposed benchmark rather than absolute returns to members; and
- the disincentives this will likely create for investing into real and unlisted assets such as important community infrastructure in Australia; and
- the lack of consideration of different asset allocation strategies, which are an influential driver of returns for members.

Unlisted Assets

We have particular concerns about the proposed treatment of unlisted assets in the benchmarking methodology. The use of a listed index – the FTSE Core Developed Infrastructure Index hedged to AUD (the "FTSE" index), is simply not an appropriate benchmark for unlisted infrastructure. The impact of this is covered in detail in the various submission made by Industry Funds Management (IFM) and we encourage the Committee to consider this in deliberations.

In summary:

1. Listed infrastructure indices display correlation with other listed indices, not with the underlying asset class.
2. The FTSE is largely exposed to North American infrastructure, and primarily across the utilities, railroads and conventional electricity sub-sectors. It includes a number of sectors that many established infrastructure funds do not invest in (e.g. conventional electricity, railroads) and comprises only 4% transport infrastructure,

which makes up the largest sub-sector of both our Australian and global infrastructure funds.

This is one example of the ill-considered approach of using listed benchmarks to assess the performance of unlisted assets.

HESTA would encourage consideration of a CPI+ benchmark for unlisted infrastructure similar to those that are frequently used by mature pension funds in Australia and the USA. These provide more flexibility to ensure the right asset mix to achieve their overall target objectives for their members. A CPI + 4% inflation-linked benchmark could be a reasonable and appropriate metric for consideration.

If the proposed benchmarks are unchanged and unlisted infrastructure becomes unattractive, then this will be detrimental to the economy and impair the ability and appetite for funds to invest in nation building projects. This would be highly undesirable as we recover from the COVID-19 pandemic.

The proposed benchmarks for unlisted property present similar challenges. Unlisted property behaves differently than listed property and this is beneficial for diversification. If a benchmark can't properly consider this dimension, then funds will be discouraged or penalised for participating in a market that provides greater diversification to a portfolio. There are options that could be considered to better reflect the performance of unused property. HESTA will provide further information to the Committee at a later date for a potential benchmark that better reflects the performance of this asset class.

A significant incentive for HESTA to invest in the unlisted market is that they are not correlated to listed markets and will diversify a portfolio away from listed market volatility to provide earnings stability, protection from inflation and portfolio risk management. The same argument can be applied to agriculture, social infrastructure, roads, transport, ports. This issue requires immediate attention.

Portfolio Approach

We also note the limitations of basing the proposed test on a "reference portfolio approach". This is not reflective of contemporary portfolio construction techniques that use a Total Portfolio Approach (TPA). This is widely regarded as the most effective method and has been adopted by the world's leading funds.

TPA refers to the management of risk and return not just through strategic asset allocation but also through asset selection within asset classes. This is a sophisticated approach, widely used in Australia and leading international pension funds, and yet would likely be considered as high-risk relative to the proposed performance test.

Schedule 3—Best financial interests duty

HESTA

- Notes funds are already obliged to act in the best financial interest of members. Any additional regulation must have a net benefit to members, considering increased costs of compliance.
- Recommends the legislation be sector neutral and clearly capture all financial arrangements including payment of profits and dividends to any entity related to the fund.
- Strongly recommends the Minister not be given power to override trustee decisions and ban certain investments.

The law currently contains a covenant requiring trustees to act in the best interests of beneficiaries. Case law has interpreted the best interests of beneficiaries to be best financial interests. Therefore, adding financial has minimal, if any, impact on the operation of the law. Trustees are already obligated to act in the best financial interests of members, as the "best interests' obligation" has been interpreted by the Courts to mean "best financial interests" since Cowan v Scargill (1985).

The Minister should not be given proposed extraordinary powers to enact regulations prohibiting certain payment types. This overreach was never opined by the Royal Commission nor the Productivity Commission. The benefit of any Trust structure is to allow those who are best positioned to know the interests of members to apply that knowledge. The role of the Regulator – recently strengthened, is to enforce this. The proposed reform would allow intervention by those without knowledge and experience of the members into this structure at an abstract level. This undermines the very nature of the trust structure used widely in Australia to align the benefits of members with decision makers.

The Final Report of the Royal Commission made no recommendation to amend the 'best interest' duty within superannuation – in fact the opposite applies. Commissioner Hayne scrutinised the best interest obligation and concluded:

> ***'I consider that the existing rules, especially the best interests covenant and the sole purpose test, set the necessary standards. Those standards should be applied according to their terms and without more specific elaboration'*** *(emphasis in original)*[11]

Given this observation by Commissioner Hayne, it is unclear why the Government believes the 'best interest' duty needs amendment.

HESTA agrees that expenditure and investments by trustees must be in the best financial interests of members and appropriate record keeping should be maintained. However, the Bill seeks to enforce this duty with a reversed onus of proof, lack of a materiality threshold and a strict liability approach. This will create additional costs to the fund, which will ultimately be borne by members, with no apparent benefit.

The Bill does not operate in a sector neutral way and does not address fees that may be above cost recovery. Consequently, it does not capture the payment of profits to related parties and dividends to shareholders that commonly occurs in retail funds. Unlike retail superannuation providers, industry funds do not distribute profit in the form of dividends to a parent company and then enact our trustee obligations over the remainder of the resources.

Both the Productivity Commission and Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) noted the behaviour of fee setting beyond cost recovery and the profiteering culture as potentially contrary to member's best interests.

We also note with concern that the Bill will:

> *"allow regulations to be made to specify that certain payments made by trustees of registrable superannuation entities are prohibited, or prohibited unless certain conditions are met. These payments are prohibited* ***regardless of whether the payment is considered to be in the best financial interests of the beneficiaries****."* (emphasis added)[12]

[11] The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission), Final Report, page 235.
[12] *Treasury Laws Amendment (Your Future, Your Super) Bill 2021 - Explanatory Memorandum –* Para 3.27 – Page 38.

This power will potentially put funds in an untenable position and create significant unknown and unquantifiable risk. The proposal is substantial given its potential application within the operation of a fund.

Regardless of the intent, funds would need to consider the risk that;

- The Minister could prohibit investment in certain assets indiscriminately at any time.
- Any prohibition could be subject to legal challenges around interpretation of permitted investments or investment classes.

HESTA's investment decisions are made by investment professionals to maximise members' savings. They are obliged to act in members' best financial interests and at arms-length of government to protect them from politically motivated changes. Policy and regulatory changes are always factored into investment planning; however, the proposed power is unprecedented, unnecessary and could cause consequences that cannot be planned for.