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Senate Economics Legislation Committee
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Subject: Treasury Laws Amendment (Your Future, Your Super) Bill 2021 [Provisions]

Dear Senators

Thank you for the opportunity to comment on the provisions of the Treasury Laws Amendment (Your Future, Your Super) Bill 2021.

Who is Mercer?

Mercer is one of the world's leading firms for superannuation, investments, health and human resources consulting and products. Across the Pacific, leading organisations look to Mercer for global insights, thought leadership and product innovation to help transform and grow their businesses. Supported by our global team of 22,000, we help our clients challenge conventional thinking to create solutions that drive business results and make a difference in the lives of millions of people every day.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $150 billion in funds under administration locally and provide services to over 2.4 million superannuation members and 15,000 private clients, including the Mercer Super Trust, which has around 220 participating employers, around 190,000 members and more than $24 billion in assets under management.

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Overall response

Mercer supports the intended direction of this Bill. In particular, we support:

- The introduction of a stapled super fund for each individual to reduce the number of multiple accounts and improve the efficiency of the superannuation industry
- The development of a consumer-friendly database and comparison tool to provide fair and simple information to assist individuals choose the best superannuation fund for them
- The introduction of performance tests overseen by APRA to improve the quality of superannuation funds and so improve member outcomes
- Improved clarity regarding the need for fund trustees to always act in the members' best financial interests

However, Mercer recommends further development of the announced policies to ensure improved member outcomes from these changes by recognising:

- The need to improve the performance tests to realistically accommodate a broader range of asset classes
- The need to recognise different volatility (or risk) that exists between different asset classes held by superannuation funds
- The suggested penalty for failing the proposed performance test is likely to adversely affect disengaged members more than any other stakeholders which represents an unfortunate outcome
- The need for the comparison tool to allow for several features of superannuation, as suggested by the Productivity Commission
- The important role that insurance in superannuation provides for many Australians and that the need for this benefit can change significantly during one's working years
- The critical role that major employers can play to encourage increased competition within the superannuation industry and so provide enhanced member outcomes throughout the whole industry

Urgent need for Regulations

The current draft Bill is very light on detail in many areas and therefore does not clearly represent the likely practice or outcomes that will occur within the superannuation industry and thereby affect fund members and beneficiaries. For example, the Regulations are expected to:

- Define a 'stapled fund'
- Define 'trustee directed products'
- List the benchmark indexes that will be used in the annual performance tests
- Specify the methods for determining the actual return for a product

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- Specify the formulas used as a basis for ranking products
- Define the form and details of the notice that underperforming funds will need to send to their members

To enable employers, the superannuation industry and other stakeholders to better understand the operations and implications of this Bill, it is essential that the draft Regulations be available as soon as possible for a significant period of consultation before your Review is completed. Without such a consultation period, it is unlikely that the Committee will be able to fully consider the broad implications of this Bill.

Recommendation:

That the relevant Regulations be released for a four week consultation period prior to the closure of submissions to your Committee.

Single default account

As indicated above, Mercer supports the concept of a single default fund for every individual. However, Mercer considers there are limitations of the 'stapled fund' approach which need to be recognised and considered prior to its implementation. These include:

- **A barrier to competition** within the superannuation industry. Without a clear framework to enable active engagement to promote fund benefits to individuals, this development is likely to lead to greater inertia and less decision making within the system. Any reduction in competition is not a desirable outcome for the longer term and potentially exposes the industry to some of the behaviours in other areas of financial services where there are a small number of large providers and little movement of individuals between them.
- The **death and disability insurance** cover provided by the "entry fund" may not be suitable for many members later in life. When the individual joins their first fund, they are unlikely to have insurance or be concerned with the insurance cover provided by this fund. However, as their working career develops and their personal circumstances change, insurance cover is likely to become more important. Hence, Mercer believes there needs to be nudges or triggers in the process to encourage individuals to review the provision of insurance when they change jobs. This is particularly the case for those who move to work in more risky industries (e.g. dangerous occupations) where cover restrictions may apply or additional cover is needed. Alternatively, others may move to less risky jobs (e.g. professional services) where considerably lower insurance premium rates may be available from some funds.

- **Employer-supported superannuation** has many advantages for members as larger employers can use their scale to secure better superannuation arrangements for their employees through lower fees and/or improved services. In addition, some employers will wish to continue to use superannuation as a benefit to attract or retain staff, whether through contributions above the SG, subsidised insurance or additional employee services. There must remain an opportunity for employers to highlight these benefits when on-boarding new employees and that such information does not constitute financial advice or fall foul of anti-hawking or design and distribution obligations legislation.
- Many superannuation funds will see fewer new members after the stapled fund reform is introduced. This is likely to lead to an increased number of fund mergers. However it is also likely to create some "orphan funds" that are unattractive merger partners resulting in a poor outcome for the remaining members of these orphan funds. Hence, the Regulations must provide **a simple mechanism for fund mergers** without either fund incurring significant costs.
- Inevitably the development of a single default account (or stapled fund) will increase the **level of marketing** by some superannuation funds as they target younger individuals who have not yet entered the labour market. An increased awareness of the brand in this generation will become critical for the long term success of many superannuation funds. However competition between superannuation products at the ages of 15 to 25 may not be in the best long term interest for these individuals. It is therefore critical that information about different superannuation options from a variety of sources become easily available throughout the whole career of an individual.

Recommendations:

- Employers should be encouraged to nominate an employer-preferred superannuation fund and be able to inform new employees of the features of this fund which they could choose to join, whilst also transferring their accumulated superannuation balances to this fund.
- Mergers between funds should be encouraged, including ensuring that a transfer-in of a poorly performing fund does not adversely affect the performance test result of the better performing fund.

Implementation risk

In view of the delay in the final legislation passing parliament prior to the planned starting date of 1 July 2021, we believe there is now a significant risk in the implementation of the stapled fund concept.

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This new process will involve employers, new employees and the ATO as part of the on-boarding process for new employees. For some major employers, who recruit hundreds of employees every month, this represents a significant exercise. Furthermore, according to the Budget papers, a manual process will be required from 1 July 2021 until a digital-based approach is available from 1 July 2022. These two systems will inevitably add confusion and additional costs for employers.

Recommendation

That the commencement date for the single default account be deferred 12 months until 1 July 2022 which will enable the ATO to develop the new digital software for employers and for the relevant on-boarding processes within employers to be properly established.

'YourSuper' comparison tool

An important part of the Government's package is the YourSuper comparison tools as the Government wants to encourage individuals to be able to choose the best superannuation product for them, which implicitly recognises that their current or initial "entry fund" may not be suitable throughout their working years.

Subsection 60J in Schedule 2 of the Bill make specific allowance for Regulations to be made "as a basis for ranking Part 6A products, or classes of Part 6A products, according to relative fee levels, investment returns or any other criterion".

It appears that the proposed comparison tool for MySuper products is deliberately simple and will show investment returns and fees, updated on a quarterly basis. Underperforming products, as determined by the annual performance test (see below), will be highlighted in the comparison tool.

As currently proposed, there is no mention of insurance which suggests that the insurance costs and benefits would be similar for all products. This is not the case as has been highlighted in a recent ASIC Report. Insurance remains a valuable benefit for most superannuation fund members.

Indeed, the Productivity Commission suggested that their proposed MySuper elevated outcomes test should cover the following items in respect of each superannuation fund:

- Administration
- Insurance

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- Investment strategy
- Advice
- Member services
- Scale

That is, any comparison tool should go beyond one or two metrics such as investment performance or fees. APRA also recognised this fact when designing its *Superannuation Prudential Standard SPS 515 – Strategic planning and member outcomes*, as did the changes to the SIS Act which introduced the annual outcomes assessments.

Although MySuper products are default products, trustees have the responsibility to act in their members' best interests; hence no two funds should not necessarily be the same. There will be differences and these differences should be encouraged to foster competition and strengthen Australia's superannuation system.

Issues with the comparison tool, as currently proposed, include:

- No inclusion of insurance costs and benefits, and the need to recognise that funds have different insurance designs and different premiums for the same insurance cover
- Double counting of investment costs if these costs are shown as part of total fees and also used to reduce gross investment returns
- Difficulties in allowing for lifecycle funds, which are recognised around the world as the best approach to de-risking for members approaching retirement. By design, these funds have several cohorts of members (with different investment strategies) which makes a single composite net investment return for the product meaningless for any individual member
- No allowance is made for the investment risk profile for the individual member, which often varies by age
- No allowance is made for fee reductions negotiated by employers or for additional contributions made by some employers to their selected MySuper product
- No allowance is made for the options, benefits and other services provided by some products e.g. intra-fund advice

The development of this comparison tool is likely to stifle innovation within the industry as the metrics used in the tool will drive the behaviour of trustees and the ongoing design of superannuation funds. In the rush to contain or reduce fees in order to be competitive, member benefits and services are likely to be reduced.

It should also be noted that ASIC requires a superannuation fund's promotional material that cites past performance figures to include a cautionary note that past performance is not a reliable indicator of future performance. It will be important therefore, that the comparison tool does not imply that a better performing fund over the last period will continue to perform better in the future. For example, a top performing fund for the last eight years may have a below median performance in the next year.

These comments do not imply that a consumer-based comparison tool should not be developed. A well designed and comprehensive tool will help consumers. However, it needs to be recognised that all consumers are not concerned with the same metrics. Superannuation is more complicated than that.

A superannuation comparison tool needs to be developed carefully recognising different consumer preferences and that future investment outcomes will not necessarily reflect the past. For example, it would be helpful to rank the relevant products for each consumer based on personal answers to three or four simple questions such as:

- The individual's age
- The individual's total balance, which could be obtained directly from ATO data
- The individual's desire (or otherwise) for insurance
- The individual's willingness to accept variation in their future investment return

Finally, it is important that the comparison tool provides clear explanations to those using the tool. That is, it should also be seen as an educational opportunity to help individuals increase their understanding about superannuation. This is common practice with most consumer-based comparison tools.

Recommendations

The Your Super comparison tool should include several characteristics of MySuper products including net investment returns (ie after fees), investment risk, administration fees and insurance.

In addition, the ranking of funds should allow for a limited number of data points from individuals so that the ranking is relevant to their personal circumstances.

Performance test and addressing underperformance in superannuation

As indicated above, Mercer supports the introduction of an annual performance test. However, given that the Regulations defining the actual performance test are not yet available, the following comments reflect some of the material published as part of the announcements in the 2020-21 Budget.

Benchmark Indexes

The Budget papers listed several benchmark indexes that would be used in the benchmark. However, a broader range of more tailored and relevant market-related indexes should be used

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to recognise the range of assets held by superannuation funds. As a minimum, we suggest the following unlisted asset indexes:

- Domestic (unlisted) private equity: AVCAL Australia Private Equity and Venture Capital Index
- International (unlisted) private equity: Cambridge Associates Global Private Equity Index
- Domestic Unlisted Property: Mercer/IPD/MSCI Australia Property Fund Index Core Wholesale
- International Unlisted Property: MSCI Global Quarterly Property Fund Index (Unfrozen)
- Domestic Unlisted Infrastructure: MSCI IPD Australian Unlisted Infrastructure
- International Unlisted Infrastructure: EDHEC Infra 300 Index (Hedged)

Some of these indexes were used by the Productivity Commission in respect of BP2, their blended benchmark portfolio which they acknowledged was more representative of superannuation funds' exposure to unlisted asset classes, and thus more closely represents how funds actually invest (in terms of implementing their asset allocations).

In addition, we suggest additional indexes should be used in respect of high yield assets and emerging market debt. Many superannuation funds have meaningful allocations to these assets and therefore to avoid "gaming" through the use of inappropriate indexes, we suggest the following indexes:

- High yield: ICE BofAML Global High Yield Index
- Emerging market debt: JP Morgan GBI EM Global Diversified

An increased number of indices will better capture the intended implementation of the trustees and therefore the fund's ability to deliver against relevant benchmarks. Fewer indices will result in an assessment that captures more than a fund's ability to deliver on their planned implementation. Such an outcome could result in some good performing funds failing the test whereas some poorly performing funds could pass the test.

The introduction of a second test

We are concerned that under the proposed single performance test, some superannuation funds may fail the test if they have taken decisions to protect their members' best financial interests; for example, by de-risking in an over-inflated market. This is similar to a type 1 error in statistics where a false positive occurs or "an innocent person is convicted".

We therefore recommend a second test be developed for funds or products which fail the initial test. This approach should reduce the probability that good performing funds or products are deemed to be under performing, which can occur under the current proposal. We recommend using a risk-adjusted measure as described in the Attachment.

The introduction of a second test will allow for deviations from the benchmark that have been made for risk management purposes and/or to generate better long term investment performance. We also note that the only other performance test of this kind in the world, as far as we are aware, is in the Netherlands and their test recognises there will be different market volatility between fixed interest assets and real assets (their terminology).

Recommendation

A second test should be introduced which takes into account the risk (or volatility) of the actual investment portfolio and therefore uses both net investment return and risk in the actual performance test.

The Attachment describes a possible return-risk approach and uses hypothetical data to highlight the benefits of such a test.

The consequences of failing the test

The current Bill in subsection 60E proposes that all beneficiaries who hold the underperforming product be informed when a superannuation product fails the annual performance test. Subsection 60E(5) proposes that this communication be by both a letter and an electronic communication. In this era of digital communication the need to send a letter by pre-paid post or courier is unnecessary and would incur additional costs to the fund, which in turn would be borne by all remaining members.

This member communication is likely to lead to a ‘run’ on the fund by the more engaged members leaving the disengaged members to bear the consequences of the failure. That is, the very cohort of members that the Government is seeking to protect are likely to suffer. We suggest it is much better if the fund or the trustees are directly affected, rather than the beneficiaries. That is, the consequences of underperformance should affect the governance of the fund and not adversely affect the remaining members.

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Recommendations

Upon failing the annual performance test for the first time, the trustee must implement an Action Plan. Possible components of the Plan could include:

a. The appointment of an independent chair of the trustees
b. The tendering of certain outsourced services
c. The review of relevant investment managers
d. Regular monitoring by APRA

If the fund is unable to meet the terms of the Action Plan within two years, there would be a compulsory Successor Fund Transfer. It is noted that the receiving fund should be protected from the consequences of receiving the poorly performing assets from the failing fund.

We would be pleased to present to the Committee or discuss any aspect of this submission with you.

Yours sincerely,

[redacted]

Dr David Knox
Senior Partner

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Attachment

The proposed return-risk investment performance test

The proposed performance test is:

Net Investment Return – (Benchmark Return - 0.5%) $\geq$ 0

Our proposed second test, taking into account both investment return and risk, would be:

$$\frac{\text{Net Investment Return} - (\text{Benchmark Return} - 0.5\%)}{\text{Benchmark Return}} \quad \text{minus} \quad \frac{\text{Portfolio Risk} - \text{Benchmark Risk}}{\text{Benchmark Risk}} \geq 0$$

The logic is that we are testing whether the level of underperformance in the first test is more than compensated by the lower risk (or volatility) taken to achieve this return. If this calculation provides a positive number, then the excess return provided by the benchmark portfolio is less than the extra risk and the product should pass the test. On the other hand, if the calculation provides a negative number, then the product would fail this test.

Risk would be calculated as the standard deviation of the actual portfolio or the benchmark portfolio, which is common practice within the investment industry.

In the following example, we consider a fund that would fail the proposed performance test but should not be considered underperforming due to their reduced risk.

Example

Let's assume the following

- Net Investment return of the actual portfolio — 6.0% pa for the last 8 years
- Investment return of the benchmark portfolio — 7.0% pa for the last 8 years
- Standard deviation of the actual portfolio — 10% for the last 8 years
- Standard deviation of the benchmark portfolio — 12% for the last 8 years

Under the proposed annual performance test in the Your Future Your Super Budget papers, this product would fail the annual performance test as the Net Investment Return is 1.0% pa below the Benchmark return and hence the "loss" is greater than the proposed 0.5% threshold.

However, under our proposed test, the calculation would be as follows:

$$\frac{0.06 - (0.07 - 0.005)}{0.07} \quad \text{minus} \quad \frac{0.10 - 0.12}{0.12}$$

equals -0.07 minus -0.17

equals 0.10 which is greater than zero

Therefore this product should pass the test due to the fact that the lower return has been offset by a lower risk and hence reduced volatility for the beneficiaries.

Conclusion

This simple example highlights the fact that the proposed test in the Budget papers with a single metric based on investment return only is not sufficiently robust and will encourage behaviour that will not always be in the members' best financial interests.

The following charts highlight the difference between the proposed test and our suggested second test.