Ai GROUP SUBMISSION

Your Super Your Future Exposure Draft Materials

DECEMBER 2020

Ai GROUP

About Australian Industry Group

Ai Group is a peak national employer organisation representing traditional, innovative and emerging industry sectors. We have been acting on behalf of businesses across Australia for nearly 150 years.

Together with partner organisations we represent the interests of more than 60,000 businesses employing more than 1 million staff. Our members are small and large businesses in sectors including manufacturing, construction, engineering, transport & logistics, labour hire, mining services, the defence industry, civil airlines and ICT.

Our vision is for thriving industries and a prosperous community.

Ai Group is the employer shareholder in the Trustee of AustralianSuper – a leading all-profit-to-members fund and a key contributor to the world-class aggregate performance of the Australian superannuation system.

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Executive summary

The Australian Industry Group (Ai Group) appreciates this opportunity to provide input to the Exposure Draft Legislation.

While Ai Group supports the higher-level objectives of the Your Super Your Future package, in this submission we identify two significant shortcomings in the approach outlined in the exposure draft materials:

- Both the exclusions from assessment of underperformance and the approach to measurement of underperformance fall short of what is required and of the Productivity Commission recommendation on addressing underperformance.
- The approach taken to protect member interests is poorly conceived and poorly designed. It fails to clarify what is meant by acting in members' best interests (or best financial interest); it proposes an illogical and unprecedented power for regulators to prohibit actions that are in members' best financial interest; and it proposes an overly prescriptive, burdensome and heavy-handed approach that conflicts with good regulatory practice and the Government's commitment to reducing regulatory burdens.

The submission also raises two shortcomings with the proposed approach to addressing multiple accounts.

Introduction

Ai Group welcomed the initial announcement of the Your Super Your Future initiative in October 2020 as one that we hoped would assist to address key areas of potential improvement as highlighted in the Productivity Commission's 2018 report *Superannuation: assessing competitiveness and efficiency* (PC Report).

In our initial response to the Your Super Your Future announcement, we welcomed the following stated objectives of the Government's initiative:

> *The Morrison Government's goal is for the superannuation system to maximise the retirement savings of all Australians. We want your money to work harder for you, so that the money you contribute today is invested in your best financial interests, allowing you to enjoy a higher standard of living in retirement.*
>
> *We also want to help you make more informed decisions about who manages your superannuation. The superannuation system is complex and members do not have access to a single, trusted and reliable source of information to help them make a better choice.*

We did however temper our welcoming comments by urging close consultation on how best to address these objectives. We also noted that it "is particularly critical that the measures of fund performance focus on net benefit to superannuation members".

In this submission we provide comments on three areas covered by the approach outlined in the exposure draft materials.

- Underperformance
- Protecting member interests
- Unintended multiple accounts.

Underperformance

Persistent underperformance of some superannuation products is a clear flaw in the current arrangements and addressing underperformance across the full range of superannuation products was a key recommendation of the PC Report.[1]

> RECOMMENDATION 4 ELEVATED MYSUPER AND CHOICE OUTCOMES TESTS
>
> The Australian Government should legislate to require all APRA-regulated superannuation funds to undertake annual outcomes tests for their MySuper and choice offerings. These outcomes tests should include:
>
> - a requirement for funds to obtain independent verification, to an audit-level standard, of their outcomes test determination, at least every three years (starting with the first test)
>
> - clear benchmarking requirements for all MySuper and choice investment options.
>
> This benchmarking should include a requirement for all investment options to be compared with a listed investment benchmark portfolio tailored to their asset allocation (with exceptions only to be granted on an 'if not, why not' basis). APRA should issue clear and specific guidance on the construction of these benchmark portfolios (drawing on the methodology established by this inquiry)….

Ai Group agrees that underperformance should be called out and addressed. The benefits of addressing underperformance will be greater if, in line with the PC Report recommendation, measures apply broadly and if underperformance is assessed by taking into account the full range of detractors from performance.

The proposals in the exposure draft fall short on each of these counts.

Coverage should be broader

Not all superannuation products are proposed to be included in the assessment of underperformance. Instead, while all MySuper products are included, only some choice products are included. However, as made clear in the PC Report's assessments, underperformance of superannuation fund products are distributed more or less in the

[1] Productivity Commission, 2018, *Superannuation: assessing competitiveness and efficiency.*

same proportion in MySuper and choice products[2] and around three quarters of member accounts in underperforming funds are in retail funds.[3]

Ai Group suggests that all APRA-regulated products should be subject to performance assessment. This is in line with the recommendation of the PC report quoted above.

The underperformance measure should be comprehensive

In announcing the Your Super Your Future package, the Government stated that it would introduce "an annual objective performance test based on net investment returns".[4]

The clear shortcoming of using the net investment returns measure is that it does not include all the costs and charges that impact on the returns received by superannuation members. As Ai Group proposed in our initial response to the Government's announcement, the assessment of performance should employ the more comprehensive measure of net benefit to members. This measure includes non-investment administration costs.

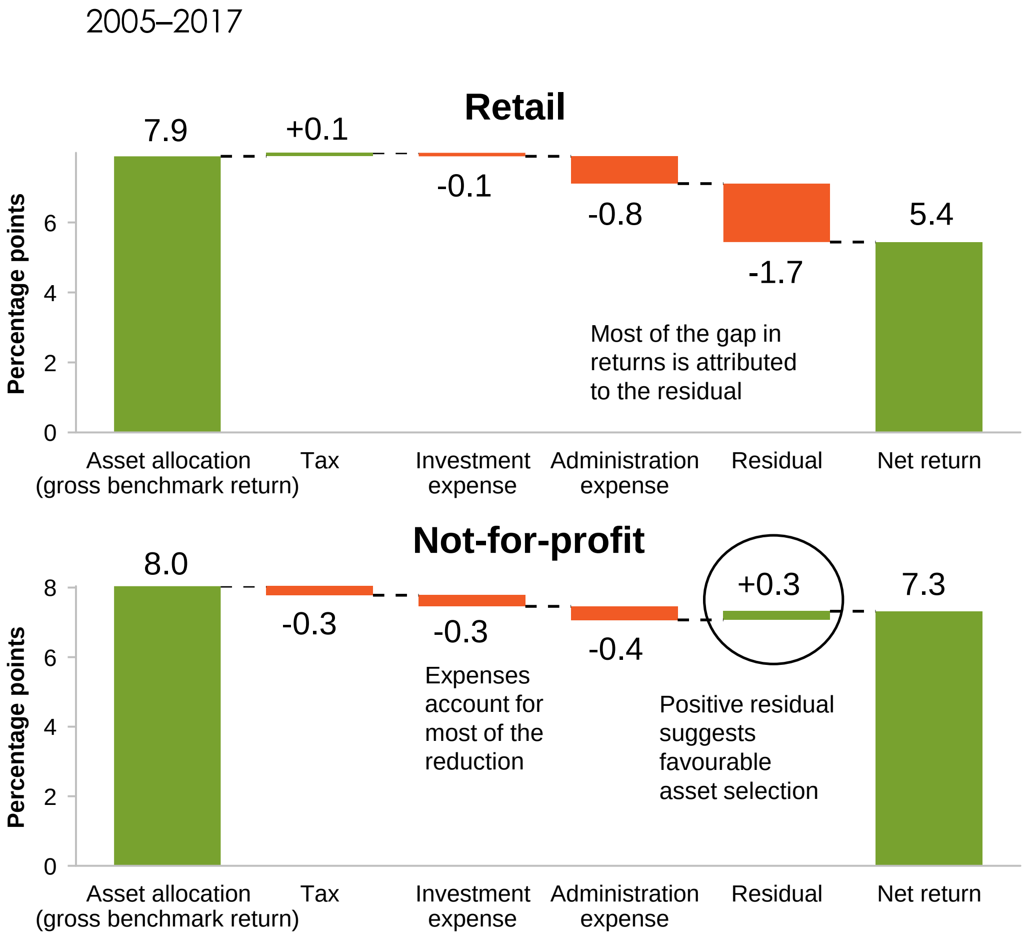
The PC Report identified administration costs as an important factor in the returns received by superannuation fund members. This is illustrated in the Chart 1 below copied from the PC Report. It identifies that administration expenses:

- accounted for 0.8 percentage points of the 2.5 percentage points difference found between the benchmark return the net return to members in the retail segment; and,
- 0.4 percentage points of the 0.7 percentage point difference between the benchmark return and the net return in the not-for-profit segment.

Clearly, administration expenses have the potential to be significant contributors to underperformance and they should not be excluded from its assessment.

[2] Productivity Commission, 2018, *Superannuation: assessing competitiveness and efficiency, Overview* pp. 11-14.
[3] Productivity Commission, 2018, *Superannuation: assessing competitiveness and efficiency, p.52.*
[4] Australian Government, 2020, *Your Future Your Super*, p.22.

Chart 1: Funds by segment: components of different returns



Source: Productivity Commission, 2018, *Superannuation: assessing competitiveness and efficiency, Overview* p. 8.

Excluding administration expenses from the measure of underperformance risks creating perverse incentives and outcomes. These include:

- the risk that less attention will be paid to removing inefficient administrative practices;
- the risk that costs are artificially shifted from an investment expense to the administrative expense category; and,
- most importantly, the risk that underperformance is incorrectly identified or incorrectly overlooked.

Using the more comprehensive measure of net benefit to members would strengthen the effectiveness of the legislation and would bring it into line with the methodology recommended by the Productivity Commission.

Protecting Member Interests

The interests of members should be central to the management and conduct of superannuation funds.

Ai Group has a long, deep and ongoing involvement in superannuation fund governance. In our experience, the best performing funds have a strong culture of putting members' interests first; they do not dilute member returns by allocating a share of investment returns to shareholders; and they frequently have member representatives on their Boards.

Our observations are strongly supported by the Productivity Commission's findings in relation to the broad patterns of fund performance and underperformance.

With a view to improving member outcomes, Ai Group strongly supports the recommendation of the Productivity Commission to provide clarity over what it means for those responsible for governance to act in members' best interests.[5]

> RECOMMENDATION 22 DEFINITION OF THE BEST INTERESTS DUTY
>
> The Australian Government should pursue a clearer articulation of what it means for a trustee to act in members' best interests under the Superannuation Industry (Supervision) Act 1993 (Cth). The definition should reflect the twin principles that a trustee should act in a manner consistent with what an informed member might reasonably expect and that this must be manifest in member outcomes. In clarifying the definition, the Government should decide whether to pursue legislative change, greater regulatory guidance, and/or proactive testing of the law by regulators. It should be informed by the findings of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Ai Group fully agrees with the range of points made in this Productivity Commission recommendation: clarity: reasonableness and the importance of member outcomes. Further, in pursuing these objectives, we support the making of a (sensible) choice between alternative regulatory approaches.

Which approach is taken should be a matter of the relative effectiveness of alternative regulatory approaches in achieving the outcomes sought by the recommendation.

The approach put forward in the exposure draft material for the Government's Your Super Your Future package falls well short of what is required:

- It fails to provide clarity about what it means to act in members' best interests (or best financial interests);
- It creates a regulatory capacity to undermine trustees' efforts to act in members' best financial interests; and,
- The regulatory approach it proposes is extraordinarily heavy-handed.

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[5] Productivity Commission, 2018, *Superannuation: assessing competitiveness and efficiency.*

These points are expanded upon below.

In Ai Group's view, the intent of Recommendation 22 of the PC Report could be achieved much more directly and with much less disruption and cost simply by the provision of clear regulatory advice about the objectives the Government is seeking to achieve. The option of this more direct and simple approach was canvassed in Recommendation 22.

Lack of clarity

The draft exposure materials introduce new, and poorly articulated concepts in identifying certain classes of expenditure and they specify different standards that would be required in making decisions about certain classes of expenditure.

In its detailed explanation of the new law, the exposure draft explanatory materials, (1.26-1.33) differentiate between at least two different categories of expenditure:

- Expenditure that is of a kind that is "core or essential to the operation of a superannuation entity" (1.29); and
- Expenditure "that might be considered discretionary or non-essential to the ongoing operation of the superannuation entity" some of which "could be strategic in nature" (1.31).

The explanatory materials state that trustees "will need to have robust quantitative and qualitative evidence" that identifies a quantifiable financial benefit to members (1.28).

However, in the case of "core or essential" expenditure, an expenditure decision:

> "would likely be regarded to be in the best financial interests of the beneficiaries" if "reporting and monitoring frameworks for such expenditure are put in place by trustees to ensure that the expenditure is necessary and competitively priced (and any ongoing expenditure continues to achieve its intended outcomes) (1.30)"

On the other hand, for expenditure that is "discretionary or non-essential to the ongoing operation of the superannuation entity" (even though it may be strategic in nature):

> "[A] business case, supported by technical analysis (including cost benefit analysis, articulation of risks associated with achieving the outcome and any mitigation strategy) and quantifiable metrics to reflect expected financial outcomes would be expected to support trustee decision making on strategic expenditure (1.31) whereas expenditures that "are not supported by an identifiable and quantifiable financial benefit to members, articulated in a clear business case, are unlikely to satisfy the requirements of the best financial interests obligation." (1.32)

In relation to investment decisions, the explanatory materials (at 1.33) state that for "investment decisions the determinative motivation for trustees must be maximising the financial returns to beneficiaries having regard to appropriate levels of risk."

The exposure draft materials fail to provide clarity about what it means to act in members' best financial interest. Instead:

- They provide different guidance about what constitutes acting in members' best financial interest for certain identified categories of expenditure and in relation to investment decisions.
- The specified categories of expenditure and investment decisions are not clearly defined.
- As a consequence, which criteria are required to support different expenditures are also unclear.
- It is also not clear that the two categories of expenditure identified are exhaustive or whether there are other categories of expenditure.
- Decision-making in relation to issues other than expenditure and investment are not identified, and criteria are not set for assessing how these other areas of decision-making will be assessed as satisfying the obligation to act in the best financial interests of members.

While some of these points might appear to be nitpickish, they need clarification and all the more so because the reversal of the evidential burden of proof (discussed below) would necessitate such clarity so that trustees and directors can have a very high degree of confidence about the evidentiary requirements for the many different types of decisions they need to make in governing superannuation funds.

Regulatory override of members' best financial interests requirement

In comparing the key features of the proposed law with the current law, the exposure draft explanatory material (p. 7) outlines a feature of the proposed law that has no equivalent in the current law. It states that "[r]egulations may prohibit certain payments, or prohibit certain payments unless certain conditions are met (regardless of whether the payment is considered to be in the best financial interests of beneficiaries)."

This is an extraordinary and illogical feature of the proposed approach. While trustees are required to act in members' best financial interests, by virtue of this proposed feature, regulations can be made that prevent them from taking actions that are in members' best financial interests.

Ai Group suggests that the pursuit of members' best financial interest should not be able to be circumvented by regulations that are themselves contrary to the pursuit of members' best financial interests.

The approach proposed is extraordinarily heavy handed

The approach set out in the exposure draft materials is a clear and dramatic departure from the general objectives of regulatory reform and is impossible to reconcile with the Government's stated objectives of reducing regulatory burdens.

The proposed approach is extraordinarily prescriptive. It attempts to impose a set of detailed requirements on the decision-making of trustees and fund directors; it unreasonably imposes an evidential burden of proof on trustees by requiring them to establish that their actions are in the best financial interest of members; and it proposes that there would be no materiality threshold below which these onerous obligations would not apply. It threatens heavy penalties for infringements.

The approach would create a red tape nightmare in the oversight of superannuation funds. Instead of concentrating on running funds in the best interests of their members, funds would be embroiled in compliance with an exceptionally intrusive regime.

For instance, would expenditure on an end-of-year event for staff be regarded as "core and essential to the operation of the superannuation entity"? What quantitative and qualitative evidence would need to be produced to establish that expenditure on an end-of-year event was in the best financial interests of members if a) the expenditure was assessed to be "core and essential"; b) "discretionary and non-essential"; or c) it was in some other expenditure category?

In summary, the approach set out in the Your Super Your Future exposure draft material to clarifying the meaning of acting in the best interests of members is fundamentally flawed.

Ai Group proposes that, instead of the prescriptive, burdensome and opaque approach proposed, close consideration should be given to the relatively simple alternative contemplated in the PC Report of clarifying what it means to act in the best interest of members by developing clear and direct regulatory guidance.

Addressing unintended multiple accounts

Ai Group strongly supports the objective of reducing unintended multiple accounts. Unintended multiple accounts mean that members are charged multiple sets of fees and they are associated with inefficiency of administration.

Notwithstanding efforts to encourage consolidation of accounts, too many members still have multiple unintended accounts.

Ideally the approach taken to reducing unintended accounts would address both the stock of multiple accounts and limit the creation of new unintended accounts in the future. If possible, the approach adopted would also seek to enhance engagement with superannuation or at least not reduce the opportunities for engagement that are already present.

In broad terms there are two approaches to addressing the multiple accounts issue.

- In the approach proposed, members would retain their initial superannuation account when they move employment unless they chose an alternative fund (account stays with member).
- The alternative approach, for new employees not exercising choice, would be for existing accounts to be consolidated into a default fund of the new employer (balance follows member).

The former approach is taken in the Your Super Your Future package.

The measures proposed however do not address the existing stock of unintended multiple accounts and, in themselves, they do not promote engagement with super.

On the other hand, the alternative approach would appear to be more able to address the existing stock of multiple accounts and would retain the opportunity that is currently provided upon a change in employment to invite employees to become engaged with their superannuation.

Ai Group urges a close consideration of whether measures adopted could also address the existing stock of unintended multiple accounts and the creation of new unintended accounts while contributing to opportunities for disengaged members to engage with their superannuation.

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