Ai GROUP SUBMISSION

Senate Economics Legislation Committee

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

MARCH 2021

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 comment on the Treasury Laws Amendment (Your Future, Your Super) Bill 2021 ("the Bill").

While Ai Group supported the higher-level objectives of the Your Future, Your Super package when it was initially announced, we strongly oppose the measures set out in the Bill and explanatory material.

We note that the explanatory material frequently invokes the Productivity Commission's 2018 Report *Superannuation: Assessing Efficiency and Competitiveness* ("PC Report") as providing a foundation for the approach taken in the Bill. In reality however, the approach taken in the Bill does not reflect the findings or recommendations of the PC Report.

- 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 flaws in the measurement of performance as proposed in the Bill would carry a high risk that the actual relative performance of funds would be misrepresented.

- 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. Compliance with these regulatory burdens would divert attention and effort away from funds' focus on the interests of their members.

- The approach to reducing multiple accounts is flawed in a critical respect. Unlike the relevant recommendations in the PC Report, it fails to provide a quality filter for stapled funds and thereby adds to the risk that many superannuation fund members would be worse off than under existing arrangements. In addition, businesses are not confident that should the Bill be passed, there would be enough time to ready themselves for a 1 July 2021 date of effect.

- The considerable differences between the approach taken in the Bill and the relevant Recommendations of the PC Report mean that the PC Report should not be used in lieu of a Regulatory Impact Statement in relation to the Bill.

While it is conceivable that the Bill could be amended to address these issues, the flaws in the approaches proposed in the Bill are so severe that we urge the Committee to recommend the Bill be rejected and for work begin on an alternative Bill dedicated to achieving the originally espoused higher level objectives.

Introduction

Ai Group welcomed the initial announcement of the Your Future, Your Super initiative in October 2020 as one that we hoped would assist to address key areas of potential improvement as highlighted in the PC Report.

In our initial response to the Your Future, Your Super 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.*[1]

We did however temper our 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".

Our comments on the Bill and the explanatory material are provided under the following headings:

- Measuring performance
- Protecting member interests
- Unintended multiple accounts
- Use of the PC Report in lieu of a Regulatory Impact Statement.

Measuring performance

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.

> 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:*

[1] Australian Government, 2020, *Your Future, Your Super.*

- *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 would be substantially greater if, in line with Recommendation 4 in the PC Report, measures apply broadly and if underperformance were assessed by taking into account the full range of detractors from performance.

The proposals in the Bill fall short on both 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 is distributed more or less in the same proportion in MySuper and choice products[2] and around three quarters of member accounts in underperforming funds are in retail funds.[3]

This is a major flaw in the Bill. Instead, in line with the Recommendation 4 of the PC Report, all APRA-regulated products should be subject to performance assessment.

The underperformance measure should be comprehensive

In announcing the Your Future, Your Super 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

[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.

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. The PC Report found that administration costs[5]:

- accounted for 0.8 percentage points of the 2.5 percentage points difference between the benchmark return and 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.

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.

The approach proposed in the Bill is flawed and, if enacted, would carry the risk that superannuation fund members would be misinformed about the genuine relative performance of different funds. A more comprehensive measure of performance is required to genuinely inform critical decisions about which funds should be entrusted with the generation of retirement incomes.

An approach that used the more comprehensive measure of net benefit to members would substantially improve the quality of information available to superannuation fund members and would be in 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 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.

[5] Productivity Commission, 2018, *Superannuation: assessing competitiveness and efficiency, Overview* p. 8.

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.[6]

> 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 Recommendation 22.

The approach put forward in the Bill and the explanatory material is fundamentally flawed and would not promote the best interests of members.

- The regulatory approach proposed is extraordinarily intrusive and heavy-handed. The combination of the reversal of the onus of proof, the lack of a materiality threshold and the nature of the discussion in the explanatory material about evidentiary requirements in relation to particular actions will impose high levels of uncertainty and unreasonably heavy compliance burdens on funds. This uncertainty and these burdens would divert the attention of managers, directors and trustees away from their central duty of acting in members' best interests.

- It would create an illogical regulatory capacity, and an untrammeled discretionary power, that would undermine trustees' efforts to act in members' best interests.

- The outcomes sought by Recommendation 22 could be achieved very simply and at much lower cost by the provision of clear regulatory guidance.

These points are expanded upon below.

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

The approach proposed is extraordinarily heavy handed and does not provide clarity

The approach set out in the Bill and explanatory 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 extremely prescriptive. It would impose a set of onerous requirements on the decision-making of trustees and fund directors; it unreasonably imposes an evidential burden of proof on trustees by requiring them to be able to prove their actions are in the best financial interests of members; and it proposes that there would be no materiality threshold below which these onerous obligations would not apply.

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.

The provisions in the Bill are intended to apply extensively to the operational decisions of superannuation funds. They cover:

> *the execution of [Trustees'] fiduciary duties in relation to the many actions trustees take in operating a superannuation entity: which include incurring day-to-day essential operational expenditure and investing the beneficiaries' money, to less frequent strategic decisions and discretionary expenditures.*[7]

The Explanatory Memorandum[8] provides a detailed explanation of the variety of evidentiary requirements required for a selection of such actions. While the material outlines the imposition of an extraordinary degree of prescription on decision-making, instead of clarifying what is required, it creates new areas of uncertainty.

For instance, it refers to a category of expenditure that "is essential to the prudent operation of a superannuation entity". This expenditure "would be likely to be regarded to be in the best financial interests of members" if " reporting and monitoring frameworks … are put in place … to ensure that the expenditure is necessary and provided on competitive terms (and any ongoing expenditure continues to achieve its intended outcomes)". While it is likely to be regarded as such, whether it would be regarded as being in the best financial interests of members would depend on "all of the circumstances of the relevant case".

This is differentiated from another category of expenditure – expenditure "that might be considered discretionary or non-essential to the ongoing operation of the superannuation entity." For this class of expenditure, funds "should expect to face greater scrutiny".

There is further category of expenditure - namely "expenditure associated with generating investment returns for members". For this class of expenditure "a

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[7] Explanatory Memorandum, paragraph 3.8, pp. 35-6.

[8] In the following paragraphs, references are drawn from the Explanatory Memorandum, paragraphs 3.33-3.39, pp.41-2.

determinative motivation for trustees must be maximising the financial returns to beneficiaries having regard to an appropriate level of risk."

Superannuation funds would need to identify what expenditure decisions fell into what categories and would need to ensure that the supporting analysis is appropriate to the category of expenditure as well as to the "quantum, regularity and duration of the expenditure."

Far from providing the clarification around acting in the best interests of member as recommended in the PC Report, the explanatory material creates considerable uncertainties:

- It is not clear what expenditure falls into what categories (or even whether the categories are mutually exclusive or exhaustive of all expenditure decisions).[9]
- It is therefore also not clear which evidentiary requirements relate to which expenditures.
- In contrast to the detailed coverage of different types of expenditures, there is next to no guidance about the evidentiary requirements for non-expenditure actions or decisions.
- It is not at all clear about the evidentiary requirements in relation to expenditures not made but, if they were made, would have been in the best financial interests of members. Expenditure not made on improving cyber security may be an example.

These uncertainties together with the reversal of the onus of proof and the lack of a materiality threshold compound the compliance difficulties created by the lack of clarity in the Bill and explanatory material. Funds would need to be ready to prove that actions are in the best financial interests of members. Presumably funds would also need to be able to prove that actions not to make expenditures (for example on improved cyber security) were in the best financial interests of members. Given these uncertainties, it is very likely that funds would presume that they would need to be ready with supporting analysis to be able to prove that the most onerous level of evidentiary requirements were met regardless of the size or nature of actions.

Regulatory override of members' best financial interests requirement

The Bill puts forward an amendment to the SIS Act:[10] "to allow regulations to be made that certain payments made by trustees … are prohibited …. regardless of whether the payment is considered to be in the best financial interests of the 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

[9] It would certainly seem likely, for instance, that expenditure could be both "essential to the prudent operation of a superannuation entity" and "associated with generating investment returns for members." Similarly, given the selective nature of investing, some investment decisions might be considered to be discretionary or non-essential.

[10] Explanatory Memorandum, paragraph 3.37, page 38.

feature, regulations can be made that prevent them from taking actions that are in members' best financial interests. This includes actions related to investing.

It makes no sense that trustees could be required to go to extraordinary lengths to ensure they are in a position to prove their actions are in the best financial interests of members while at the same time creating a power for these actions to be circumvented by regulations in a way that is contrary to members' best financial interests.

Recommendation 22 of the PC Report could be given effect readily by issuing regulatory guidance

As noted above, Recommendation 22 of the PC Report calls for the provision of clarity about what it means to act in members' best interests.

While the proposals contained in the Bill and elaborated upon in the explanatory material would impose an extraordinary and diverting compliance burden on superannuation funds, they do this without achieving the clarity that was recommended by the Productivity Commission.

Yet, as canvassed in Recommendation 22 itself, the required clarity could be achieved very directly by issuing clear regulatory guidance. That regulatory guidance could simply clarify that members' best interests would not be served when members' best non-financial interest would come at the expense of members' best financial interest. This is a phrasing adapted from paragraph 3.9 of the Explanatory Memorandum.

In summary, the provisions in Schedule 2 of the Bill would not protect members' interests. Instead, they would embroil funds in an extraordinarily heavy-handed regime and divert them from the task of promoting the interests of their members. Astonishingly, they would create a regulatory power to prevent funds from acting in members' best interests. In comparison, providing the recommended clarity over the meaning of members can be achieved readily by providing simple and direct regulatory guidance.

Addressing unintended multiple accounts

Ai Group strongly supports the objective of reducing unintended multiple accounts and we have welcomed several initiatives taken in recent years to reduce their prevalence.

Members are charged fees on all their accounts and, particularly in cases when unintended accounts are held in superannuation funds that are underperforming, there is a clear risk that aggregate retirement balances will be lower than they would be if accounts were consolidated.

At the same time, there is also a risk that the consolidation of accounts could detract from some retirement balances. This will occur if accounts are consolidated into underperforming funds.

The Bill proposes an additional measure to address multiple accounts. The proposal involves a fundamental change in the selection of superannuation funds for new employees who do not nominate a superannuation fund for the employer to contribute to on their behalf.

Under the proposed approach, if the employee does not nominate a fund, the employer would need to check with the Australian Tax Office (ATO) whether the employee has a "stapled fund" and, if there is a stapled fund, contribute to that fund. The stapled fund will likely be either the last superannuation fund that received contributions made on the employee's behalf or (if there are multiple funds) the fund with the largest account balance. If the ATO advises that there is no stapled fund, for instance if the employee is beginning their first job, once the ATO has confirmed that there is no stapled fund, the existing arrangements for choosing a default fund will apply.

Before coming to our major criticism, we note that businesses are not confident they will be ready to implement the stapling proposal by the intended start date if the Bill were to be enacted.

Although the stapling approach is based on Recommendation 1 of the PC Report, that recommendation was accompanied by other recommendations aimed at lifting the quality of funds and weeding out underperformance. These included Recommendations 2 and 4 of the PC Report. Recommendation 2 proposed a best in show shortlist of high-performing funds that could be default funds and Recommendation 4 proposed 'elevated MySuper and choice outcomes tests'. In the latter, funds that failed these tests would be required to remediate their performance or the relevant products would be required to be withdrawn from the market.

In contrast to these recommendations, a major shortcoming of the approach put forward in the Bill is that it does not propose creating a quality filter on stapled funds. As a result, the Bill does not address the risk that consolidation can result in worse member outcomes. In the absence of a quality filter for many outcomes will be worse under the proposed approach than under the existing arrangements.

A key finding of the PC Report was that, notwithstanding the relatively strong performance of the default segment of the industry, there was considerable diversity of performance. Approximately 14 per cent of members' default accounts were in underperforming default products. These findings are summarised in the Chart over the page which is reproduced from the PC Report.

An interesting feature of the existing approach to default fund selection is that unintended multiple accounts serve to diversify amounts held in super and thereby reduce the risk that all of a member's balances are held in underperforming default products.

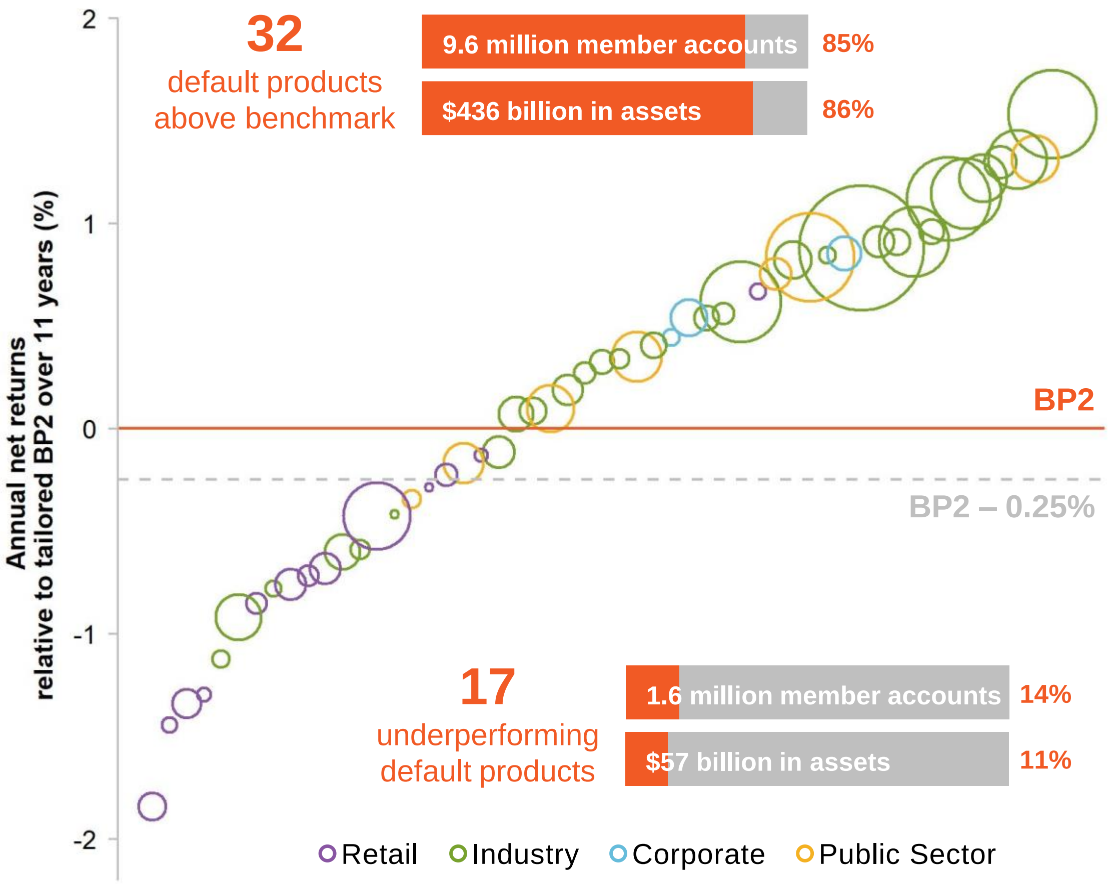
Under the approach proposed in the Bill, members originally defaulted into poor performing funds and who do not subsequently actively choose a fund, will be stuck in the underperforming fund until their retirement. There is no opportunity for them to be defaulted into a high performing fund when they change employment.

For example, if there is a 14 per cent chance of being defaulted into a poor performing fund, under the current arrangements, an employee who is defaulted into an account with each change of employment would stand a 0.3 per cent chance of having all their superannuation in three underperforming accounts once they were in their third job. Under the approach proposed in the Bill, the same employee would stand a 14 per cent chance of having all their superannuation in an underperforming product.

Default products: vastly different net returns, with 1.6 million member accounts in underperforming default products

Performance relative to individual products' benchmark portfolios, 2008–2018

Size of circles indicates the size of each product's assets under management



Sources	PC analysis of APRA (2018a, 2018k), financial market index data (various providers), and SuperRatings data.		
Benchmark	Product-tailored BP2.		
Coverage	53 of 105 current MySuper products covering 76% of member accounts and 75% of assets in all MySuper products as at June 2018.		
Survivor bias	Yes.	**Selection bias**	Yes.
Further results	4 products performed less than 0.25 percentage points below BP2 (150 000 member accounts and $12.6 billion in assets).		

Source: Productivity Commission, 2018, *Superannuation: assessing competitiveness and efficiency, Overview, Figure 6, page 12.*

Clearly this is not an argument against effective measures to address unintended multiple accounts, but an argument in favour of more rigorous approaches to addressing underperformance among superannuation funds. Unless underperformance is addressed, the stapling proposal will increase the risk that members will have all their superannuation assets in a poor performing fund.

The use of the PC Report in lieu of a Regulatory Impact Statement

A recurring theme in this submission is that, while the explanatory material invokes the PC Report as a foundation of the provisions put forward in the Bill, in fact the Bill departs markedly from the recommendations of the PC Report.

- The approach to performance measurement in the Bill falls well short of Recommendation 4 of the PC Report in critical respects.
- The provisions in the Bill put forward in the name of promoting member interests, do not achieve the objective of clarification as set out in Recommendation 22 of the PC Report and would impose considerably higher compliance burdens than could have been envisaged in the PC Report.
- The stapling proposal in the Bill picks up on an element of Recommendation 1 of the PC Report but does not adopt either the remaining parts of Recommendation 1 or the complementary Recommendations (2 and 4) aimed at meaningfully weeding out underperforming funds.

The differences between the PC Report and the approaches proposed in the Bill are certainly too substantial to permit the PC Report to be used in lieu of a Regulatory Impact Statement. Yet the Explanatory Memorandum (at page 4) reports:

> The Productivity Commission's report, *Superannuation: Assessing Efficiency and Competitiveness*, has been certified as a process and analysis equivalent to a Regulation Impact Statement for the purposes of the Government decision to implement this measure.

The importance of the issues addressed in this Bill; the nature of the provisions it contains and the compliance burdens in would impose, warrant a close and thorough assessment of the regulatory impact of the provisions in the Bill. The PC Report is not equivalent to a Regulatory Impact Statement in relation to these provisions and should not be used as such.

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