19 April 2024

Ms Victoria Woolley
Superannuation Efficiency and Performance Unit
Retirement, Advice and Investment Division
The Treasury
Langton Crescent
PARKES ACT 2600

Via email to **YFYS@Treasury.gov.au**

Dear Ms Woolley,

AustralianSuper submission to Annual Superannuation Performance Test – design options, Consultation paper

AustralianSuper welcomes the opportunity to provide a written submission in relation to the *Annual Superannuation Performance Test - design options, consultation paper,* March 2024. We acknowledge and thank the Government for its desire to improve the annual performance test so that it meets its objective of holding trustees to account for delivering the best financial outcomes to members.

AustralianSuper is Australia's largest superannuation fund and is run only to benefit members. AustralianSuper has over 3.3 million members and manages over $315 billion of members' assets. AustralianSuper's vision is to be Australia's leading superannuation fund, in the world's best system for members.

Given the compulsory nature of Australia's superannuation system, AustralianSuper strongly supports measures that are aimed at holding trustees to account for the retirement outcomes they deliver and the fees they charge and, through effective consequences, providing members with a safety net when performance is poor. We have therefore long been a supporter of the annual performance test (performance test) and agree that the current test has been instrumental in delivering better outcomes to members by removing underperforming products.

The consultation paper acknowledges that the performance test can be improved to better meet its objectives and to also ensure that it endures. Previous submissions by AustralianSuper have also identified issues that prevent the performance test from fully meeting its objectives.

In our view, the current performance test should be retained and further developed, towards the measurement of the total return received by a member, net of costs and adjusting for risk. This total return measure is the most simple, holistic, effective and enduring measure of whether a fund is generating strong returns for members.

We therefore welcome this review as an opportunity to explore improvements to the design of the current performance test. However, our overarching position is that any changes to the performance test following this review should improve the extent to which the current test supports good member outcomes. It should not result in a lower threshold, reduced scope or more lenient consequences for products that fail the test.

AustralianSuper considers that the following improvements are needed to the performance test:

- All APRA regulated products, including retirement products, should be subject to a performance test. This will ensure only strong long-term performing funds and retirement products receive and manage

Australians' superannuation contributions, through their working lives and into retirement. If a product is too complex to be subject to a performance test, then we question whether it should be offered to members.

- Historical administration fees should be included in the performance test. Applying a one-year timeframe for administration fees does not reflect the long-term nature of superannuation and is inconsistent with the timeframe on which performance is measured.

- The test should be simplified to better measure member outcomes, ensuring it captures all fees and all returns and improves the extent to which it assesses the investment strategy design and not simply how well a fund has implemented its own investment strategy.

AustralianSuper supports the principles contained in the consultation paper. The principles provide a useful measure to guide both consideration of design models and changes to the performance testing framework now, and over time. Of the principles, *improves member outcomes* is fundamental and should be given the greatest weight. An additional principle of *simple* should be included to underpin a holistic measure of whether a fund is generating strong returns for members and reduce product providers' ability to 'manage' the test to achieve a good performance test outcome.

Detailed comments on the consultation paper are provided in the Attachment.

We would be pleased to provide additional information or to discuss this submission in further detail. If that would be of assistance, please do not hesitate to contact me or Nick Coates, Head of Government Relations and Public Policy (ncoates@australiansuper.com).

Yours sincerely

Paula M. Ben

Paula Benson AM

Chief Officer, Strategy & Corporate Affairs

Attachment

Options for reform

1. Do you agree with these principles? Are there any other principles that should be considered?

We support the four principles proposed by Treasury in the consultation paper and consider that they are useful for guiding assessment and development of the performance testing framework, now and over time. However, we think they could be expanded in the following ways to better support the primary focus of the consultation paper:

- The first principle, *improves member outcomes*, is fundamental however this cannot be achieved unless the performance test measures the 'net benefit' to members of investing their superannuation in a particular product.

- The third principle, *widely applicable and transparent*, states that the test should be applied to 'as many product types as possible'. In our view, the performance test should be applied to all APRA regulated products, including retirement products, although we recognise there is more work to be done. This will ensure only strong long-term performing funds and retirement products receive and manage Australians' superannuation contributions, through their working lives and into retirement.

- Finally, we believe that an additional principle of *simple* should be included. The test should enable trustees and APRA to easily quantify the value delivered to members in an enduring way. Incorporating simplicity in the design of the four identified principles would result in a more holistic measure of whether a fund is generating strong returns for members. A *simple* and transparent test would also remove the ability for funds to game or disguise underperformance in one area with overperformance in another.

The four principles identified by Treasury, and our proposed additional principle of *simple* should be weighted in terms of importance before being considered against the proposed testing options. It is our firm position that *improves member outcomes* should be the priority when determining the future of the performance test. We believe that *simple* as a principle would serve to enhance the other principles identified by Treasury.

Design options

The principles proposed by Treasury in the consultation paper, with the adjustments outlined above, provide a useful guide for assessing the design options and considering future development of the testing framework.

As the preference map in the **Appendix** to this submission demonstrates, of the options presented, we do not believe the current test best fulfils all the principles identified by Treasury. We consider a single metric test such as a simple reference portfolio or peer comparison is a preferable approach, but we recognise this will take some time to develop.

Therefore, given that the current test is performing reasonably well in delivering better outcomes to members by removing underperforming products, we think it should be retained and improved, including by adopting a simpler design. We expand on this in our response to the specific questions below.

1. Status quo – SAA Benchmark Portfolio

Despite its well-documented limitations, the current test is largely fulfilling the objective of protecting members from underperforming products. It performs reasonably well against the key principle *of improves member outcomes* at the system level. Further improvements to the current test could be made to:

- make it simpler and ensure it better meets the objective of holding trustees to account for delivering the best financial outcomes to members, rather than just measuring the implementation of investment strategy, and

- extend its reach to better meet the *widely applicable and transparent* principle by measuring fees over the same period as performance is measured - eight years and increasing to ten – to reflect the long-term nature of superannuation and the outcomes received by members.

Therefore, the current test should continue until any replacement test is developed and implemented. Retaining the current test would also ensure public confidence is maintained and pre-existing efforts to generate interest and knowledge of the test are not lost. Crucially, the current test should not be made easier to pass for any product as this would raise questions around products which have been required to close to new members, or exit the industry, and dilute the key objective of the test. The current test is also understood by funds and in use.

AustralianSuper therefore supports the retention of the current performance test, with enhancements that include fewer benchmarks and measurement of the total return received by a member, net of costs and adjusting for risk. We expand on this further in our response to **questions 2-8**.

2. Is assessing the implementation of a strategy, as opposed to assessing the choice of strategy itself, a strength or weakness of the current framework?

Assessing the implementation of a strategy is a weakness of the current framework, especially for MySuper products where the trustee is responsible for setting the strategy and should be measured on how they do so. Assessing the implementation of a strategy only measures a fund's ability to implement its chosen strategy, not whether the strategy is effective in generating strong returns for members. Through using a strategic asset allocation (SAA) approach funds are motivated to 'hug' the relevant benchmark, rather than seek to deliver maximum return to members. This design can ultimately reward successfully implemented sub-optimal investment strategies.

3. Can the existing methodology be materially improved, such as by further calibrating benchmarks, to largely address unintended consequences? How could these improvements overcome the incentive to benchmark hug, and remove barriers to invest in emerging asset classes?

As outlined above, the current test design can be simplified. Further calibration, such as different or more detailed benchmarks, will likely reinforce the risks of 'benchmark hugging' that come from the current detailed specification of a series of asset class benchmarks. This comes at the expense of considering net returns as the key determinant of a well-designed product.

4. What asset classes do you consider require better coverage in the test? What asset classes are covered well by the existing test?

In our view, fewer benchmarks is better than more. Ideally relative performance would be assessed against a single-metric test such as a simple reference portfolio, or a peer comparison of risk adjusted return.

We do not believe that additional benchmarks or more granular benchmarks will improve the effectiveness of the current performance test. We also question the value of adding complexity from a member and comparison perspective.

Whilst some in the industry have advocated for more asset classes and benchmarks to ‘neutralise tracking error’, this only serves to further eliminate the incorporation of asset allocation and portfolio construction decisions in the test. Consequently, the test becomes an even more granular attribution exercise – where each fund compares itself against an increasingly granular and self-defined SAA.

Adding more asset classes/sub-asset classes, will likely result in the performance test becoming more permissive in measuring how effective the strategy has been in generating returns for members.

5. Do you consider additional indices covering additional asset classes should be added to the test? If so, please provide the following details for each of your recommendations:

> **a. Description of asset class**
> **b. Name of recommended index covering the above asset class, including the length of time data is available on the index**
> **c. Details of appropriate fee and tax assumptions for such an asset class**
> **d. Explanation of why you consider this index is appropriate for inclusion**

As set out above, we do not think additional indices covering additional asset classes are needed. We favour rationalising the current number of benchmarks. However, a preferable solution would be to move to a simple reference portfolio.

6. How should the test cater for new asset classes in the future?

If the test is simplified to a simple broad benchmark as suggested above, additional asset classes would not be needed.

Adding additional asset classes would serve to add additional complexity to the test and would be unlikely to improve member outcomes. Logically, the only reason to add an additional benchmark to the current test would be to facilitate the introduction of an asset that underperforms assets currently tested. This is unlikely to be a positive development for members and would serve to undermine the original purpose of the performance test which is to raise industry standards.

7. Should the threshold for failure be recalibrated for some products? What evidence supports the need for a different threshold? How could a different threshold deliver better long term returns to members?

The threshold for failure should not be recalibrated for any product. Recalibrating the threshold for failure would result in members being exposed to products which do not seek to maximise risk adjusted returns, resulting in worse outcomes.

AustralianSuper does not support changes to the test that allows the test to account differently for ESG/climate investments than it does for other types of investment risk and opportunity. Investors factor ESG/climate risks into their investment decision making as they do with other types of risk, and with the same goal – maximising the risk adjusted returns delivered to members. The pricing and adjustment of such factors is a feature of financial markets and there is no need for adjustment. For example, the MSCI World benchmark exposure to the ‘Energy’ GICS sector decreased from 12% to 4% over the decade from 2012 to 2022.

We believe that the current test already provides sufficient motivation to innovate and seek out opportunities that support government transition activity. Special treatment of climate risk/opportunity may cause adverse outcomes by impacting how capital allocation occurs in relation to the transition.

8. Would retaining the current framework but moving to a simpler structure, such as a simple-reference portfolio of only bonds and equities, address some of the concerns with the current test?

As set out above, our view is that a simpler structure with fewer benchmarks is better than more: ideally relative performance would be assessed against a single-metric test such as a simple reference portfolio, or a peer comparison of risk adjusted return.

A simpler structure could also measure the 'net benefit/net returns' to members of investing their superannuation in a particular product, instead of net investment returns. Net benefit is the investment return minus the administration and investment fees and costs and transaction costs and taxes.

A 'net benefit' test measures actual returns members receive into their accounts. Despite some adjustment, the current test basically measures net investment returns to members and in doing so obscures the effect of historical administration fees on returns.

Further, a 'net benefit' measure is more reflective of the lived experience of members and a clear statement of whether their best financial interests are being met.

Treasury would be aware that the Cooper Review and Productivity Commission also advocated for administration fees to be include in performance measures. [1]

2. Alternative single-metric test – Risk-adjusted returns

As advocated in our previous submissions[2] we think that a single metric test such as a peer comparison or simple reference portfolio is an effective way to measure overall member outcomes. Of all the design options, these models perform best against the key principle of *improves member outcomes*.

While using a single-metric test would address industry concerns with the current test, particularly around 'index hugging' which constrains its ability to genuinely achieve the goal of ensuring the best performance outcomes for members in the system, improvements can also be made to the current test to better achieve this outcome.

Measuring the total net return received by a member, adjusting for risk adjusted returns provides a simple, holistic, effective and enduring measure of whether a fund is generating strong returns for members. A peer comparison of risk-adjusted returns would promote competition amongst trustees and remove the incentive to 'manage' to specific indices. A peer comparison would also allow members to rapidly ascertain whether a trustee is adding sufficient value when compared to a peer group.

The Sharpe ratio is a weaker candidate to replace the current performance test. The Sharpe ratio has the logical aim of evaluating risk adjusted returns. The drawback of this option is that it uses return volatility as a proxy for an investment options' risk. However, observed volatility is a short-term measure of risk, and we do not believe this is appropriate. In our investment decision making and governance, and in our public disclosures we use risk metrics that focus on the ability of an investment option to meet a longer-term return objective. For example, the investment

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[1] *Super System Review, Final report*, 2010, Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness – Inquiry report*, report to the Australian Government, 2019

[2] 23 December 2020, submission on the *Your Future, Your Super* exposure draft legislation, 18 March 2021, submission on the *Treasury Laws Amendment (Your Future, Your Super) Bill* 2021, 27 May 2021, submission on the *Your Future, Your Super* draft regulations and associated measures, 14 October 2022, submission to the *Your Future, your Super* review, 2 May 2023, submission on draft *Superannuation Performance Test regulations*, 2023.

objectives of AustralianSuper's balanced option are to beat Consumer price Index by more than 4% per annum over the medium to longer term, and to beat the median balanced fund over the medium to long term.

However as set out above, such a test would take time to develop and as the current test is performing reasonably well in delivering better outcomes to members by removing underperforming products, we think the current test should be retained and improved, including by adopting a simpler design.

We do not have a response to **questions 9-14** as an evidence base is needed to fully assess the impact of such a test.

3. Multi-metric test

We do not support the development of a multi-metric test on the basis that it would add substantial complexity and would not meet the *simple* principle. It would also likely be less *widely applicable and transparent* and less *efficient*. Most importantly, it may not improve member outcomes as trustees may feel less pressure to consider overall performance given the proposed need to pass the majority, but not all, metrics. Pursuing a multi-metric test would also serve to undermine the confidence developed in the current test which could be effectively further delayed and sidelined as this more complex process is developed.

Using three metrics could open the door to watering down the effectiveness of the test and increasing the risk of gaming through increased complexity. Complexity in design of the test, such as having multiple steps or rules increases the risk that the test will not achieve its outcome of removing poor performing products.

We do not believe that using a Heatmap would necessarily improve member outcomes given the potential overlap of metrics currently utilised and the lack of clear direction when it comes to weighting the metrics currently used.

We do not have a response to **questions 15-25** as an evidence base is needed to fully assess the impact of such a test.

4. Alternative frameworks

We do not have a response to **questions 26-28** as we have not considered an alternative framework.

Broader considerations for reform

Scope of the test

In our view, if a product is so complex that it cannot be held to account, consideration should be given to whether it should be offered. This should be an overarching consideration that informs the scope of the test.

29. What are the most important considerations for performance of retirement products?

With superannuation balances continuing to grow as the system matures, and life expectancy continuing to rise, members are increasingly likely to remain in the retirement phase of the system for multiple decades. The performance of retirement products has a significant impact on the outcomes that these members experience; members in retirement phase are equally- if not more - deserving of protection from poor performing products. We therefore support the expansion of scope and retirement products should be subject to some kind of performance test or quality filter. The key principles, expanded in the way we have suggested in our response to **question 1** should apply equally to a performance test for retirement products. However, we also accept that there are complexities in the retirement phase that will need to be addressed.

While we support a performance testing framework at the product level, we also note the important role the Retirement Income Covenant plays in ensuring funds deliver optimal income outcomes to member cohorts (noting that for some cohorts this will be achieved through more than one product), taking account of the particular needs and risks relevant to members in the retirement phase.

30. If the test were to expand to retirement products, would they require a different test to the accumulation phase? Would the test differ for different retirement products?

While there are additional elements of performance that are particularly relevant to the needs of members in retirement (income volatility, management of risks and probable/actual levels of household income), elements of investment performance and fees remain relevant to achieving better financial outcomes for members. This is particularly the case for account-based pension products, where the underlying investment performance and fees can be subject to an assessment of performance.

A framework for assessing the performance of lifetime income products will need to be considered further but transparency of fees and costs, and the features or benefits that are provided in return, will be a key element.

Prior to the development of a retirement product performance test or quality filter, focus must also be placed on ensuring the portability of products, including longevity products, to ensure members can move from products that are identified as being poor-performing.

31. How could longevity products be most appropriately assessed? How could the products be compared?

The development of a performance assessment framework for longevity products is an area that requires further work. Transparency of fees and costs would present a strong starting point; the consideration of benefits, which could include both quantitative and qualitative elements, is likely to be based on individual needs, risk tolerance and income profile. It could be the case that initially, an assessment in the form of a quality filter provides some member protection from poor products with excessive fees, while supporting ongoing innovation in this segment of the market.

32. Do you agree that retirement phase, single-sector and externally-managed products are suitable for testing? Why or why not?

In our view, all APRA regulated superannuation products, including retirement products, should be subject to a performance test – although we recognise that further work is needed. This will ensure only strong long-term performing funds and retirement products receive and manage Australians' superannuation contributions, through their working lives and into retirement. If a product too complex to be subject to a performance test, then we question whether it should be offered to members.

Testing all APRA regulated accumulation products would hold all products to the same standards of accountability, create a level playing field and ultimately provide the benefits of performance testing to all members.

The Productivity Commission was very clear that trustees are responsible for products that they design and offer, and products where members make active choices are no exception, including as noted in the consultation paper, single-sector products.[3] Members of these products deserve to know how they are performing relative to others, regardless of whether they have 'chosen' the product.

In February this year, ASIC published Report 779 *Superannuation choice products: What focus is there on performance?* The report examines why some members continue to invest in persistently underperforming choice investment options and the role of trustees, advisers and advice licensees. A key finding of the work was 'that there

[3] Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness – Inquiry report*, report to the Australian Government, 2019

is often insufficient focus on performance and a lack of transparency about persistently underperforming investment options.'[4] The report highlights a range of concerns about trustee practices and the consequences for members who place their superannuation in underperforming choice products. The report provides a further evidence base to support performance testing of choice products.

As noted above, we also support some kind of performance test or quality filter for retirement products. With members increasingly likely to remain in the retirement phase of the system for multiple decades, and the potential adverse impact of poor performing retirement products on members' retirement income outcomes, we think it is important that members have some protection as they do in the accumulation phase.

The ATO comparison tool should be expanded to cover all tested products so members are able to make simple comparisons around returns and fees.

If a product is so complex that it cannot be held to account, consideration should be given to whether it should be offered. As a minimum, the Target Market Determination should explicitly state that the product cannot be tested and the ATO comparison tool should identify the product and provide a warning that is has not been tested.

We do not support exemptions for externally managed or single sector products. Performance of investment options relative to a benchmark is still achievable.

33. Should different assessment methods be applied to different cohorts of products?

It is unclear what is meant by 'different cohorts of products'. As a general proposition we do not support re-calibration of the test for different products, we consider that performance of investment options relative to a benchmark for accumulation products is generally achievable but we recognise that frameworks for assessing some retirement products need further thought.

34. Do you agree that the 'other products' outlined above are unsuitable for testing? If you think the 'other products' (or a sub-section of these products) are suitable for testing, how could they be appropriately tested?

We agree that other products should be tested for the reasons described above**.** Further work would be needed to arrive at a suitable performance test.

35. Under each design option, how could the test accommodate cohorts that are suitable for testing? For example, using different metrics or benchmarks for performance for different cohorts.

Further consideration and analysis is needed.

Fees

We do not have detailed comments on **questions 36-40**. However, we agree with the overarching principle that the performance test should hold trustees to account for the investment performance they deliver as well as the fees they charge to members. Together, high investment returns and low fees deliver a strong net benefit for members.

41. How many years of fees data is appropriate to test? Should a greater weighting be given to certain years?

Fees should be measured over the same period as performance is measured - eight years and increasing to ten – to reflect the long-term nature of superannuation and the outcomes received by members.

No compelling reason has been advanced for why fees should be measured over a shorter time-period. The current approach represents an inconsistency at the heart of the performance test and allows funds to adjust their administration fees to improve short-term performance outcomes which may not reflect long-term administration savings.

Further, aligning measurement of fees with performance will incentivise funds to keep fees low over the long-term by rewarding long term-improvements in fees.

Consequences

We agree that clear consequences have been largely effective in eliminating underperformance. We struggle to see how they have resulted in 'unintended consequences'. Therefore, we do not support reducing the consequences in any of the ways suggested in the consultation paper. What is critical is that only performing funds receive Australians' super contributions.

We do not have specific responses to **questions 42-46** because the current test has been successful at removing underperforming products. Any changes that weaken consequences for underperforming funds have the potential to dilute important consumer protections.

Barriers to consolidation

47. Are there any key barriers to consolidating closed and underperforming products? What quantitative evidence is there of these barriers? How do these weigh against other reasons a person may choose to remain in a product?

We cannot think of any barriers that would outweigh the need to ensure that members are placed in performing products.

48. What evidence do trustees use to demonstrate that remaining in a closed and underperforming product is in the best financial interests of members, compared to moving to a performing product?

Consistent with our response above, we cannot see how remaining in a closed and underperforming product can ever be in the best financial interests of members.

49. What is the process or criteria that trustees use when deciding on what product they will transfer members to when consolidating underperforming products?

Consistent with our response above, the key criteria trustees should use is whether the product to which they will transfer members passes, or ideally, exceeds the test and whether the transfer can be achieved within a reasonable timeframe so member balances can continue to grow.

50. Should APRA receive increased regulatory powers to direct superannuation trustees to consolidate underperforming products?

We think that the legislation should require funds that have failed the test twice to transfer members to a product that passes, or ideally, exceeds the test. This approach is preferable to APRA relying on discretionary powers as the consequences of failure will be consistently applied and transparent.

Appendix

As the preference map below demonstrates, of the options presented, we do not believe the current test best fulfils all the principles identified by Treasury but should continue until any replacement test is implemented.

Options	Improves member outcomes	Effective and efficient	Widely applicable and transparent	Enduring	Simple	Total
(3) Status quo	3	2	2	2	1	**10**
(6) Single-metric – Sharpe ratio	2	1	2	2	2	**9**
(2) Single-metric – Peer comparison of risk adjusted returns	3	2	2	3	2	**12**
(1) Single-metric – Simple reference portfolio	3	2	3	3	3	**14**
(5) Multi-metric - Heatmap	2	1	1	2	1	**7**
(4) Multi-metric - Targeted three metric	2	1	1	2	1	**7**

Chart key	Preferred		Acceptable		Not supported	