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Director
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Submission – Draft Regulations – Superannuation Performance Test

Thank you for the opportunity to provide a response to the proposed Superannuation Performance Test Regulations 2023.

Rest is supportive of measures that seek to ensure that the retirement savings of Australians are well-managed in high-performing funds. We note, however, that the proposed regulations fail to address many of the significant problems with the performance test that was raised by our, and other participants', response to the *Review of Your Future, Your Super Measures* consultation.

We remain of the view that, even if amended as proposed by the regulations, the performance test:

- does not appropriately address high-performance, transparency and comparability across the superannuation system,
- continues to distort actual net benefits delivered to members, through the approach to fees, and
- continues to adversely affect investment decisions and limit investments in certain assets and asset classes, including potential nation-building assets.

If the test is to be extended beyond default MySuper products, we consider that it should extend to all investment options, not just those that are “trustee directed products”. If the performance test only applied to the default options, the consumer protection rationale of the test is clear: additional protections for members who may not actively choose the default option. However, once extended into choice products, the rationale for including only investment options with allocations across multiple asset classes is unclear. The performance test focusses on the efficiency of implementation of investments against specified benchmarks (which is common to all investment options) whereas the “trustee directed products” definition only applies to investment options with multiple asset classes (the efficacy of which is not tested under the performance test).

Having said that, we consider that the “one-size-fits-all” design of the performance test is significantly challenged when extended beyond the default MySuper products. This is because choice products may have been deliberately designed for members who want:

- a shorter or longer time horizon frame than the lookback period specified in the annual performance test. We note that Rest’s membership is diverse – with those nearing retirement focussing on options with a shorter investment horizon than the lookback period, and those entering the working force having a much longer investment horizon than the lookback period; and/or

- an investment portfolio that diverges from the asset class benchmarks specified in the performance test. We note that a significant proportion of Rest's membership has chosen an investment option that expressly focusses on sustainability themes.

The design of such investment options is disclosed to members in the *Product Disclosure Statement*, and otherwise, prior to members choosing those investment option(s). It would be possible to design a performance test that better assesses performance against the disclosed design intention of investment options. Such a test would accord better with Fund's existing design and distribution, and disclosure, obligations.

We remain concerned about the distorting effect of the use of only the most recent relevant administration fee and expenses (RAFE) in metrics used in the performance test. Use of only the most recent RAFE inaccurately reflects the benefit that has been delivered to members in previous years, and this should be amended to reflect the RAFE relevant to each year of performance to prevent this distortion effect.

Given the noted challenges of the design of a universally appropriate test across the superannuation system, we also continue to maintain that there is opportunity to reconsider the consequences of the failure of the performance test, and tailor them to the circumstances. Rest continues to support a multi-step or flexible approach to performance test failure that appropriately addresses the matters that led to the result. This may include specific APRA oversight of the planning steps that a fund is taking to address the underperformance, or assistance to find an appropriate merger partner, if that is deemed to be the desired outcome.

Our comments in relation to particular matters raised by the proposed regulations are set out in the Appendix.

To discuss any aspect of this submission, I invite you to contact Sarah O'Brien, General Manager, Regulatory and Technical Services directly on 0400 399 330 or via email on sarah.o'brien@rest.com.au.

Yours sincerely,



Vicki Doyle
CEO

Appendix - Comments on Superannuation Performance Test Draft Regulations

Test period

Different investment options are designed and distributed for different investment periods. A single lookback period is inappropriate for all products.

We note that when the lookback period was 8 years, the test would only (usually) apply once an investment option had a 5 year performance record. The effect of this was that an underperforming investment option couldn't be closed to new members until its 6th year at which time it had a performance record equivalent to 75% of the lookback period. As the stated intention of the extension of the lookback period is to "sharpen the incentive of trustees to focus on long-term decision making"¹, it seems inappropriate to retain the relatively shorter 5th full year as the threshold for the first assessment when a 10 year lookback period applies. For a 10 year lookback period, a threshold of 7 full years' performance seems more appropriate.

Recommendations

- The lookback period should be 10 years, or if shorter, reflect the investment period for which a product is designed.
- The performance test should not be applied to enable an investment product to be closed until it has had a performance record equivalent to 75% of its lookback period.

Administration fees

The proposed Regulations maintain the approach to calculating the "actual" RAFF based on the most recent financial year. This continues to distort the performance test away from the actual net benefit delivered to members by retaining the existing inaccurate / manufactured basis of calculation. An approach to administration fees and costs which better aligns to the actual net benefit delivered to members across the entire lookback period better promotes transparency and comparability across the superannuation industry, while still providing an impulse to sustainably reduce administration fees and costs into the future.

Recommendation

- The actual RAFF should be the administration fees and costs paid by a member across the entire lookback period, rather than just the administration fees and costs in the last financial year.

¹ Exposure Draft Explanatory Memorandum, page 2

Benchmarks

We note that the effect of the proposed Regulations is to retrospectively apply new benchmarks for the entire test period (ie from 1 July 2014 onwards) across new compositions of (sub)asset classes and utilising new data sets.

This approach is problematic because:

- it is inconsistent with the stated rationale for the performance test to “seek to ensure that superannuation products have their performance assessed against an objective, consistently-applied benchmark”². Significant changes to benchmarks and groups of assets that apply retrospectively cannot be said to be either objective nor consistently applied;
- the rationale of assessing performance against benchmarks is to identify the benefit or determinant of investing differently to the benchmark. That presupposes that the benchmark is investible and is known at the time the investment decision is made. We note that some of the proposed benchmarks continue to be uninvestable. We also note that it is inconsistent with that rationale to retrospectively apply new benchmarks to different compositions of assets, given that investment decisions were made in view of the then applicable benchmarks to particular assets. This is particularly notable given that the proposed benchmark for International Unlisted Property did not exist prior to the publication of the proposed Regulations. Any comparison to an uninvestable benchmark is arbitrary; a better test for the relevant asset classes would be a benchmark which reflects the intention of that asset class’s contribution to the product objective (eg, a CPI+ target);
- it represents a significant change in methodology and benchmarks, which may result in funds who had failed then passing on new methodology and benchmarks (and vice versa). Such significant amendments to a test with significant punitive consequences should not be considered to have a “minor regulatory impact” only.

Recommendation

- Any changes to benchmarks and the (sub)asset classes they apply to should only be prospective.
- Benchmarks should either be investible or reflect the product’s investment objective.

Alternative asset class

The approach to alternative assets continues to be problematic. The alternative asset classes are designed to be uncorrelated (or lowly correlated) to equity and fixed interest returns. Accordingly, it would be better tested against an investment option’s investment objective rather than the equity and fixed interest benchmarks (in whatever proportion applies to the new classification of Alternative strategies).

² Explanatory Memorandum to the *Treasury Laws Amendment (Your Future, Your Super) Bill 2021*, paragraph [2.2] page 15

Recommendation

- The benchmark for the alternative asset class should be the investment option's investment objective.

Tax assumptions for Australian equities

The benchmark for Australian equities continues to assume a 0% tax rate. The rationale for this approach appears to be that the tax expense of this asset class should, across the long term, approximately equate to the value of franking credits received. However, for this assumption to be correct over the lookback period, there would effectively need to be an equal number of years where there are no capital gains ("down years") and those where there are ("up years"). If this is not the case, the tax effect can result in a material difference between the benchmark return and the return generated from an efficient passive implementation. This is inconsistent with the rationale of the performance test.

Recommendation

- The Australian equity benchmark should be the S&P/ASX 300 grossed up by the value of the franking credits with the same tax rate assumptions as are applied to other asset classes.

Currency

The proposed amendments to Regulation 9AB.5 allow product-level currency hedging ratios to be imputed across asset classes with an international domicile. This amendment calculates a currency hedging ratio as one minus the option-level foreign currency exposure divided by the sum of the strategic asset allocation to all internationally domiciled assets. The resultant hedge ratio is then applied across all asset classes with an international domicile (whether the benchmark is hedged or not). This approach is flawed as it applies a hedging ratio across internationally domiciled asset classes that do not have foreign currency exposure in their benchmark.

Recommendation

- Where foreign currency exposure is reported at the product level, calculate the currency hedging ratio as the product-level foreign currency exposure divided by the sum of allocations to asset classes that have an international domicile with an unhedged benchmark (i.e. the covered asset classes identified in items 2, 3, 4, 5, 6 and 7 of the table in regulation 9AS.17).