14 October 2022

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

By email: YFYS@treasury.gov.au

Dear Sir/Madam,

Subject: Submission – Review of Your Future, Your Super Measures

We are pleased to provide this submission on the Government's review of the measures implemented by the Treasury Laws Amendment (Your Future, Your Super) Act 2021 ("YFYS review").

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Question 1: Does the measurement of actual return using strategic asset allocation affect risk-taking behaviour by superannuation trustees?

In our view the major factors that influence investment-related member outcomes (before administration fees), in order of importance, are:

1. the overall level of risk taken in an option
2. how this level of risk is varied over time
3. the strategic asset allocation chosen to implement the desired level of risk
4. performance relative to the strategic asset allocation due to active risk and implementation.

In relation to each of these, the use of strategic asset allocation for calculating the performance test benchmark has:

1. little impact – the benchmark seeks to match the overall level of risk (albeit imperfectly)
2. some impact – the use of dynamic asset allocation can increase the risk of failing the performance test due to increased tracking error, which may discourage this approach. Some trustees will see this as an area in which they can add value relative to the performance test benchmark, while trustees who do not are likely to change their strategic asset allocation more regularly to avoid mismatches between their strategic asset allocation and actual asset allocation
3. some impact – the degree of impact varies significantly by asset class depending on the benchmark indices for each asset class. For instance, equities may be more attractive than alternatives because it is easier to manage the risk of failing the performance test in the former. We expand on this in our response to question 2 below
4. high impact: the use of strategic asset allocation as a benchmark places the focus squarely on active risk relative to this strategic asset allocation, discouraging funds from taking significant active risk and encouraging more passive investment. This is a trend that we are seeing in the approach to the management of equities allocations in particular.

Of more concern is the impact that the use of strategic asset allocation for measurement has on the focus, use of time and governance budget of funds. The fundamental issue with using strategic asset allocation as the benchmark for the performance test is that performance relative to strategic asset allocation is only one factor (and a reasonably minor one at that) in determining member outcomes, as per the hierarchy described above.

As the test currently stands, a trustee that (1) chooses a level of risk for a product that is inappropriate for members, (2) increases that risk at the top of the market, decreases risk at the bottom of the market and (3) builds a poorly designed strategic asset allocation will pass, the test so long as performance relative to that strategic asset allocation is sufficient and any changes in overall risk are reflected in the strategic asset allocation. Conversely, a trustee that (1) creates a product that matches members' needs, (2) adds value through adjusting risk over time and (3) implements a well-diversified and well-constructed strategic asset allocation, but underperforms relative to this strategic asset allocation, will fail the test and may ultimately have to close to new members.

This is not to say that performance relative to strategic asset allocation should not be measured and monitored, e.g., as part of the APRA Heatmaps. However, the significant consequences of the performance test, compared with the consequences of performing poorly on other measures in the Heatmap, push trustees to have an outsized focus on SAA-relative risks, reducing the focus on areas that are more significant to member outcomes.

While the current performance test does indeed represent a “clear and objective test”, we do not believe that there is any one single test that can adequately assess the performance of funds given the many factors that influence member outcomes. Indeed, the APRA Heatmap has been constructed in recognition of this reality, with multiple measures across multiple areas used to assess fund performance.

The small number of products that have failed the performance test in the first two years suggests that (other than Trustee Directed Products (“TDPs”) – the extension of the test to which we argue against in response to questions 8 and 9 below) APRA is in a strong position to engage directly with trustees whose products are underperforming relative to this test.

Consequently, we suggest that consideration be given to removing the automatic nature of the current consequences of failing the performance test and replacing this with greater powers for APRA to direct funds to notify members of underperformance and/or close to new members where there is not adequate justification for poor performance across a range of Heatmap metrics. We expand on this in our response to question 6 below.

Question 2: Does the current set of indices used to calculate benchmark returns unintentionally distort investment decisions or reduce choice for members? If so, is there a way to adjust the benchmark indices while maintaining a clear and objective performance test?

While the current set of indices is reasonably comprehensive in most asset classes, we do believe that there are two key areas where the current indices do not provide adequate coverage, thereby distorting investment decisions: alternatives and fixed interest (including credit). As a result, in addition to a move away from active management across asset classes, we have seen evidence (both from superannuation funds themselves and flows from investment managers) of:

- reduced appetite for alternative investments, particularly those that are genuinely diversifying to equities – as these are measured against a benchmark with 50% weighting to equities
- fixed income portfolios being constructed cognisant of the long-duration, nominal, government-dominated benchmarks used in the performance test.

Unlisted assets take longer to deploy and redeem from, but we may also see a reduction in allocations to these asset classes, particularly infrastructure where individual portfolios can look very different to the composition of the benchmark, and offshore investments, given the Australian focus of the benchmarks for both international unlisted property and international unlisted infrastructure.

Sustainability focused and ethical investment are also made more challenging by the performance test as it currently stands, as decisions that involve deviations from standard benchmarks (e.g. through the use of exclusions) can create benchmark-relative risk, even if the risk/return characteristics are expected to be neutral or beneficial to members over the long-term.

The result is that funds are likely to head in the same direction with:

- less active management
- lower allocations to alternatives
- more benchmark-aware approaches to fixed interest.

While there remains scope to differentiate on risk levels and strategic asset allocations, the overall impact of the performance test is likely to be a smaller (due to mergers) and more homogeneous group of MySuper options. This trade-off between choice and protecting members may be acceptable for MySuper products given the significant lack of engagement of many MySuper members and noting that the aim of the MySuper changes was to provide a “simple, cost-effective, diversified product” – with the performance test arguably pushes funds further towards “simple” and “cost-effective”, though arguably away from “diversified”.

Below we outline some additional indices that we believe would reduce the unintentional distortion of investment decisions and potential for a reduction in choice for members, while maintaining a clear and objective performance test.

1. Fixed Interest

We believe that the current set of benchmarks for fixed interest create a set of incentives and disincentives that may lead to poor outcomes for members.

We are particularly concerned about the potential for the narrow set of fixed interest benchmarks to stifle innovation that may lead to poor outcomes for members. While this is possible in MySuper portfolios, it is likely to have a more pronounced impact on lower risk TDPs and single sector options. These options typically have high allocations to cash and fixed interest, with Australian fixed interest measured against the Bloomberg Ausbond Composite 0+ Yr Index and International fixed interest measured against the Bloomberg Barclays Global Aggregate Index (hedged to AUD). These benchmarks have interest rate durations of around 6 years and 7 years respectively.

Benchmarks that encourage funds to reduce benchmark “noise” through investing in long duration nominal bonds could result in options which:

- have an outsized exposure to duration – which results in risks to members’ savings during periods of rising interest rates
- are highly exposed to rising inflation – leading to the potential for significant erosion of members’ purchasing power when they reach retirement
- have higher cash exposures and lower bond exposures (in order to reduce duration) – resulting in lower returns to members.

We also note that a superannuation sector that is overly exposed to Australian interest rate duration increases the prospect of a greater reliance on the Age Pension (due to capital losses from bonds) occurring at the same time that Government borrowing costs are rising.

As a result, we recommend the introduction of three additional fixed interest benchmarks that cover:

- Inflation-linked bonds - the Bloomberg AusBond Inflation Government Index
- Short-duration bonds - the Bloomberg AusBond Composite 0-3 Year Index
- Long-duration bonds - the Bloomberg AusBond Composite 10+ Year Index.

2. Credit

A second concern we have is that superannuation funds typically have sizeable allocations to credit, which are often comparable in size to their allocations to infrastructure and property. However, while both infrastructure and property now have several benchmarks included in the performance test, currently credit investments are treated as fixed interest, meaning they are benchmarked against indices that include only investment grade bonds and which have a heavy bias towards government bonds.

As a result, for riskier credit such as high yield bonds, leveraged loans, emerging market debt and some securitised credit, there is a significant mismatch between the risk characteristics of the underlying investments and the benchmarks that they are being measured against. This creates two key issues:

- the efficacy of the performance test is reduced, as the opportunity set is not being accurately matched between the investments and the benchmark
- there are incentives for funds to over-allocate to credit investments in a bid to increase expected return relative to the performance benchmark, without being penalised for the additional risk being taken.

While the breadth of the fixed interest and credit universe makes benchmarking a more challenging exercise, we believe that modest changes to the proposed benchmarks would have a meaningful impact on the efficacy of the performance test. Specifically, we propose:

- continuing to benchmark investment grade government and corporate fixed interest using the existing approach, but with the inclusion of the three additional benchmarks proposed in the Fixed Interest section above
- adding one additional benchmark – the Bloomberg Barclays Global High Yield Index – that better matches the characteristics of the riskier types of credit described and which could be used for all credit investments that fall into the “Fixed Income Non-Investment Grade” category (asset class characteristic 1 under APRA Reporting Standard SRS 550.0)

We believe that this is a pragmatic compromise which improves the benchmarking of risky credit without needing to introduce a unique benchmark for each sub-sector of the credit universe (i.e., it does not require a new benchmark for each of the high yield, leveraged loans, emerging market debt, and other sub-sectors.)

3. Alternatives

For alternative assets that currently included in the “Other/Commodities” asset class, a 50/50 global equity / global bond benchmark is currently used.

Investments which are included in this category are wide-ranging and include strategies such as:

- hedge funds or skill-based strategies
- strategies that aim to obtain exposure to “alternative” risk premia such as momentum, value, carry, volatility, and others
- strategies that invest in traditional asset classes, but which use a dynamic approach to manage the exposure to these, in the expectation of producing better risk-adjusted returns than a purely static approach
- commodities.

All of these alternative assets are attractive to investors because they tend to be lowly correlated to the more conventional superannuation fund investments such as equities, unlisted assets, and bonds and so they can play a very useful role in diversifying (and reducing) overall portfolio risk. If implemented effectively, this results in a smoother pattern of overall fund returns, which has clear benefits for members as they approach and enter their retirement years.

A key metric in determining the diversification benefit provided by such strategies is their sensitivity or “beta” to global equities. Typically, the beta of such strategies is less than 0.5; but by comparing them to a benchmark that comprises 50% global equities (and 50% global bonds) they are effectively being compared to a benchmark that has an equity beta of 0.5. The implication is that such strategies would then need to generate a return equivalent to their benchmark with a 50% equity weight in order to reduce the risk of underperforming this benchmark. However, for alternative assets with an equity beta of less than 0.5, this is a difficult benchmark to beat on a consistent basis, even over rolling eight-year periods, and so the net effect is that the benchmark currently acts as a disincentive for investors to pursue strategies that provide strong diversification benefits (because of their low equity beta.)

Whilst there is no single benchmark that is suitable for all assets that fall into the Alternatives category, for simplicity reasons we suggest that a combination of global equities and cash[1] is a suitable starting point, but that the mix needs to be adjusted to reflect the beta or sensitivity to global equities of the actual investment. For example, for a skill-based strategy which has an equity beta (based on an ex-ante assessment) of 0.2, a benchmark made up of 20% global equities and 80% cash would be more appropriate.

While this introduces an element of subjectivity into the selection of the appropriate benchmark for each investment in the "Other" category; responsibility for determining the appropriate mix could be given to the trustee, with confirmation to be provided by the fund's asset consultant and / or the Regulator.

We believe that in order for this approach to work, one additional statistic would need to be reported to APRA – i.e., the estimated beta to global equities of the investment. We believe that it should be possible to include this in the reporting proposed under APRA Reporting Standard SRS 550.0.

As an alternative, a broader range of indices for the "Other" category could be introduced, ranging from 100% equities / 0% cash through to 0% equities / 100% cash, in increments of 25%. This would result in five benchmarks for the "Other" category and would allow a fund to select the most appropriate benchmark for each investment in this category.

While the approach outlined above may lead to concerns that super funds will 'game' the system, in reality this potential already exists – funds wishing to outperform the existing benchmark for the "Other" category are incentivised to invest in strategies that have an equity beta of more than 0.5 (i.e., by investing in strategies with a higher correlation to global equities); or, if their existing strategies have a beta to equities of less than 0.5, to avoid investing in these altogether (to avoid the risk of benchmark underperformance). Either way, the potential diversification benefits of these strategies are likely to be reduced, compromising the effectiveness of portfolio outcomes.

We believe that this approach, while not perfect, achieves the ambition of introducing additional benchmarks that better reflect the opportunity set that trustees are seeking to exploit in the Alternatives sector, thereby improving the efficacy of the performance test in assessing the quality of their implementation.

Question 4: What are the longer-term impacts of the performance test on market dynamics and composition? How will these factors impact on long-term member outcomes?

We expect the performance test to contribute to the broader trend of fund mergers and, ultimately, result in a smaller number of funds in the market. These funds are likely to be larger on average and given that larger funds have generally exhibited stronger long-term performance, we believe that further fund consolidation is likely to improve member outcomes.

[1] We suggest the use of cash rather than global government bonds, as global government bonds have significant interest rate duration risk that is often not present in alternative assets that have a low equity beta. However, it is possible that in addition to specifying the equity beta for an alternative asset, a fund could also specify the most appropriate cash or government bond index to be used in the benchmark.

There is potentially a limit to this process, however. Consolidation among the 140 distinct funds (as at 30 June 2021) most likely improved overall member outcomes. It is less clear that consolidation among (say) 20 funds – once that point is reached – would continue to do so.

In addition, we expect less variation between MySuper options and less innovation, due to the constraints placed on funds by the performance test and the limitations of the test itself. The likely reduction in alternative asset classes may lead to increased volatility in MySuper portfolios, though the impact on long-term member outcomes may be more muted.

Our primary concern in relation to long-term member outcomes is in relation to the potential extension of the performance test to non-MySuper options. As discussed further in our response to question 8, we believe that the performance test will limit innovation and therefore provide less choice to members. While we believe this is an acceptable outcome within the MySuper universe due to the need to protect disengaged members, we also believe it is important to foster an environment outside of MySuper that allows for engaged members to choose options that are less constrained by a set of indices that do not (and arguable cannot) account adequately for the full breadth of investment strategies that could be implemented for members.

Question 5: Is there evidence to indicate that the notification and website publication requirements have been effective at encouraging members to consider, and switch to, alternative products? Are there ways this could be improved?

Where a product fails the performance test, the level of prescription in the notice (“underperformance notice”) that must be issued under section 60E(2) of the Superannuation Industry (Supervision) Act 1993 (“SIS Act”) means that trustees are unable to warn members of potentially materially adverse consequences from switching products that may apply in some cases – such as the loss of employer-paid insurance cover or fees. Most employers who meet the cost of fees or insurance cover for their employees do so only in the corporate fund or sub-plan and not in any other fund that the member might elect to switch to (that is, they are not simply packaged benefits that an employee can choose to cash out). These benefits could run to hundreds or thousands of dollars per year, depending on the member’s age and the level of employer subsidisation.

While we acknowledge that more flexibility is available to trustees in relation to disclosing the test failure on the fund website, in our view this is not sufficient to mitigate the impact of members receiving a formal letter from their fund that may be materially misleading due to the lack of flexibility mentioned.

Transition to retirement income streams (“TRAPs”) are products that are not treated as retirement phase income streams for taxation purposes – that is, income from the assets supporting such products is not exempt from income tax. Similarly, TRAPs are not excluded from the performance test under section 9AB.2(2)(a) of the Superannuation Industry (Supervision) Regulations 1994 (“SIS Regulations”) because they are not retirement phase income streams. Many trustees offer members who hold TRAPs the same investment options as they offer Choice product holders. Therefore, trustees will be required to issue the standard underperformance notice to members who hold a TRAP if the underlying TDP in which it is invested fails the performance test. However, for a TRAP holder, moving to another superannuation product involves the commutation of the existing income stream and purchase of a new income stream. There are therefore materially different issues to be considered by a TRAP holder compared to a Choice product holder. The existing underperformance letter fails to consider these products and issues.

Question 6: Have the consequences been effective at encouraging trustees to improve their performance or merge with better performing funds? Are there ways this could be improved?

While the evidence is somewhat limited at this stage, it does appear that measures in place have already had significant success in reducing underperforming MySuper products through a combination of consolidation and improved performance from ongoing products.

In 2021, 13 MySuper products failed the performance test. Due to a combination of funds merging and improved performance from ongoing products, only four MySuper products failed a second time in 2022 – a significant improvement given the seven-year overlap in returns between the two tests.

The four funds with products that failed have also undertaken significant steps, with:

- three funds currently in the process of merging with larger funds
- the remaining fund closing its MySuper product prior to the second failure.

As a result, the evidence thus far suggests that the measures in place are resulting in swift actions from trustees of products which underperform.

Nonetheless, we consider that the operation of the test would be improved by introducing an additional step before a fund which has underperformed the benchmark is deemed to have failed the test. The additional step would be confirmation by APRA that no exceptional circumstances exist which would justify negation of the failure result. In making this assessment, the criteria applied by APRA could include:

- evidence of structural changes to the fund that addressed the likely cause of underperformance (e.g., change in investment personnel or fund management, or a merger or outsourcing of the investment function)
- changes in product design (e.g., strategic asset allocation, or administration fee basis) which are designed to (and are considered likely to) address the underperformance.

This extra step would be triggered by application by the trustee of the fund concerned, and if no submission were made the failure assessment would stand.

While we acknowledge that such an additional step would introduce subjectivity into the test, thus eliminating its ‘bright line’ form, we would see it as being justified for the following reasons:

- to ensure prompt actions by trustees to rectify underperformance are given due recognition. As mentioned above, over time consolidations arising from failures could be counterproductive and result in otherwise soundly managed and valuable funds being lost to the system
- in the interests of natural justice where underperformance is due to ‘exceptional circumstances’, and to avoid the adverse impact of a failure designation becoming a reviewable decision.

Question 7: Are the measures in place to resolve underperformance sufficient given the potential for members to be stapled to these products? How can the system best support members in underperforming products?

Based on the evidence thus far (as discussed in our response to question 6), we view the combination of the performance test and APRA’s broader powers as sufficient checks to ensure that members who are stapled to funds that underperform are adequately protected.

We do note that the performance test has only been in place for two years (and stapling only since 1 November 2021) and that the full impacts of both the performance test and stapling are only likely to be fully assessable over the long-term.

Given the reactions of trustees whose products have failed the performance test so far, as well as the short time period, there is no way to assess what would happen if a perennially underperforming fund were to seek to remain in operation – despite its MySuper option being forced to close. Were this to occur, it is important that APRA both has and uses powers to intervene to ensure members are protected.

Question 8: Are there any significant issues to be expected when the test is extended to TDPs? Is so, how could these issues be addressed?

While we acknowledge the desire to remove persistently underperforming products from the superannuation system and to ensure trustees are accountable for the performance of all their products,

in our view there are some significant concerns with extending the performance test to TDPs. These concerns are in addition to those mentioned in our responses to questions 1 and 2 above.

We believe that there is a clear role for non-MySuper options that offer differentiated approaches, such as:

- more diversified products with significant allocations to alternatives that are genuinely diversifying – and therefore have high tracking error to an equities/bonds benchmark
- defensive options with high exposures to fixed income but low interest rate duration in order to manage volatility – something that is challenging given the current array of fixed interest benchmarks
- products with a clear focus on protecting against inflation – noting that this is a primary risk for many members and may be particularly front of mind for those in or close to retirement, but would have very high relative risk to performance test benchmarks
- products with a clear focus on protecting against extreme downside events – this may involve accepting lower returns in “up” markets to protect in “down” markets, something that is likely to result in performance test failures after extended equity bull markets
- products with a religious, ethical or sustainability focus which reflect the beliefs of members, but do not track closely to traditional benchmarks.

With disengaged members now catered for within the superannuation system via MySuper products that are subject to limitations due to being covered by the performance test, in our view the role of choice products is increasingly important in offering a broader set of options to other superannuation members. The current performance test approach discourages funds trustees designing portfolios to meet specific member needs such as those above. Applying the test to TDPs in the same way that it has been applied to MySuper products risks further limiting innovative product design and therefore the breadth of choice for members, who by definition are engaged with their super.

While the suggested changes to benchmarks that we have included in our response to question 2 would help to mitigate some of the issues noted above, we do not believe that changes to indices can fully eliminate the likely impact on the choice of options that members have.

TDPs are already subject to significant scrutiny via the APRA Heatmap and the member outcomes covenant in section 52(9) of the SIS Act. In addition, some trustees have set up their new member onboarding mechanisms such that all new members initially join the MySuper product and must elect to switch to another product from there rather than by joining a TDP directly. The consequence of two successive failures of the performance test by the MySuper product means that the entire fund is effectively closed to new members in these cases. Further, since the release of the 2021 performance test results, APRA has imposed additional licence conditions on two trustees that required them to implement a strategy to merge with a larger, better performing fund. While both of those funds failed the 2021 performance test, APRA did not state that this was the only reason the licence conditions were imposed.

In our view, therefore, there is already sufficient scrutiny of TDPs, and their trustees and APRA has sufficient powers to ensure the interests of choice members are protected. The extension of the performance test to TDPs will serve only to have an adverse impact on innovation and choice for engaged members.

Question 9: What would be the impact of extending the current performance test to other Choice products (such as single sector or retirement products)? How could any issues be addressed?

Retirement products

In our view, the extension of the performance test to retirement products introduces material concerns which do not apply to MySuper products or TDPs (other than TRAPs as discussed in our response to question 5 above).

We note the comments on page 8 of the Consultation Paper to the effect that it may not necessarily be possible to test investment performance of products such as annuities where product holders do not bear the investment risk. In our view it would not be appropriate to apply the performance test to the following types of superannuation products where members do not bear the investment risk, and which are either not generally commutable (other than in very limited circumstances) or where a similar income stream is unlikely to be able to be purchased at equivalent cost (in the case of defined benefit lifetime income streams):

- lifetime pensions under section 1.06(2) of the SIS Regulations
- life expectancy pensions under section 1.06(7) of the SIS Regulations
- commutable lifetime defined benefit pensions under section 1.06(9A)(b)(iv) of the SIS Regulations.

In the latter case, we would note that employees may have an entitlement to such pensions under employment contracts. Closing the product to new members (as would be required if the product failed the performance test twice consecutively) may result in a breach of such employment contracts.

In order for a member to move their superannuation from one retirement income stream to another in a different product, the member must commute their existing income stream and commence a new one in the new product. Depending on the type of income stream and how long the member has held it, this may result in significant adverse consequences for the member for social security purposes, potentially including loss of access to the assets test exemption if the test was to be extended to certain lifetime annuities or defined benefit income streams such as those listed above.

In addition, in our view the nature of the members who hold retirement income steams must be taken into account. While many retirees are and remain actively engaged with their superannuation, there remains the possibility that a trustee will be required to send the underperformance notice to members of advanced age or who are suffering from cognitive decline or other issues. Not all such members will have a financial adviser or other trusted individual who can assist them in taking action in response to the letter, which means the letter may achieve little more than cause them stress.

We therefore do not recommend the extension of the performance test to these products.

Single sector options

Arguably there is a stronger case for extending the performance test to single sector options than for TDPs, as asset allocation is less relevant – making benchmark-relative performance a more reliable indicator of product performance.

Our main concern in relation to extending the test to single sector options is similar to that for TDPs – the potential for the test to stifle innovation and limit choice for members. This concern primarily relates to areas where the benchmarks used are not an accurate reflection of the underlying investments – particularly alternatives and fixed income.

As an example, constructing a standalone fixed income option for members who want capital stability and inflation protection is challenged by the long-duration and nominal nature of the current set of fixed interest benchmarks used. Such an option would likely have failed the performance test over the seven-year period to 30 June 2021 (a period of falling interest rates), even if it had performed strongly relative to the objectives of the members investing in the option – but it would have provided much more capital stability in 2022.

In our response to question 2, we have provided some suggestions regarding additional indices that could help mitigate this concern in relation to these asset classes, should single sector options ultimately be subject to the performance test.

Our suggestion is that these options be captured within an APRA Heatmap, which includes the performance test measure, but with APRA provided powers to determine whether the consequences of performance test failure are warranted.

Question 14: To what extent are employers putting into practice processes to seek stapled fund details from the ATO? How has the implementation of stapling changed onboarding, software, and payroll processes for new employees?

For large employers with bespoke digital onboarding platforms very little has changed as a result of the introduction of stapling. The onboarding process generally already required the employee to make a choice (with the employer default fund being one of the potential choices) before moving on to the next onboarding task. In our view, it is highly unlikely that a large employer with a digital onboarding platform will need to revert to the stapling step.

It is common for small to medium employers to offer generic digital onboarding systems, often provided by a third-party, to assist with the onboarding process. Some of these services are at no or minimal cost to the employer. They offer a bundled range of services to the employer for their employees. Some of these platforms offer a selection of funds from which a new employee can easily select their preferred option for their SG contributions. But very little has changed as a result of stapling for employers using these services.

Some small employers have continued to use the ATO Standard Choice Form ("SCF"). Very little has changed on the ATO SCF – part 1 of section A enables the employee to nominate their employer default fund very simply by ticking the appropriate box. This is the simplest option for completion of the form, and we would expect very few employers to need to revert to a stapled fund when the SCF is completed and returned to the employer. The need to revert to stapling is therefore only likely to occur when the new employee does not return a completed form.

It therefore continues to be more likely for the employer default fund or other chosen fund to be nominated by employees ahead of the stapling process being invoked and stapled fund details being required from the ATO.

Question 15: Are there any barriers in the current framework to achieve the intent of the stapling reform?

The stated intent of stapling is to reduce duplicate member accounts in multiple superannuation funds. However, as outlined in our response to question 14 above, onboarding processes means that the need to identify a stapled fund is often not required as new employees are in effect required to choose a superannuation fund. Even for employees who do this using the SCF, the easiest path is often to just choose the employer's default fund.

Therefore, one of the main barriers to reducing the number of duplicate accounts is the current onboarding process and the structure of the SCF. While the SCF refers to the stapling process, in our view it would require amendment to enable the stapled fund to be more easily selected by the employee to activate the stapling requirements.

Question 16: What is the actual, or likely, impact of stapling on insurance coverage?

From an insurance perspective, the goal of stapling to reduce unnecessary duplicate accounts is one we would agree with. Reducing unnecessary duplicate insurance cover will reduce the impact of premiums on retirement savings, especially if the duplicate cover is income protection insurance where policy offsets generally ensure that maximum total benefits cannot exceed the claimant's pre-disability income (or usually some fraction of that, such as 75%).

The stapling legislation, however, has had only marginal effect on insurance duplication, because the changes implemented by the Treasury Laws Amendment (Protecting Your Superannuation Package) Act 2019 ("PYS legislation") had already delivered significant reductions in the total number of insured members in superannuation. The PYS legislation eliminates insurance coverage on inactive super accounts which have not received a contribution or rollover in the previous 16 months unless the member actively opts in to retain coverage. Many large super funds have seen a 30% or larger drop in their insured membership as a result. The stapling legislation has so far contributed little in terms of insurance duplication because the ongoing requirements of the PYS legislation will force the cancellation of duplicate cover in inactive accounts.

For the reasons elsewhere in this submission, the proportion of stapled members has proved to be lower than might have been first anticipated, so the effect of stapling on super insurance is yet to materialise and is likely to be muted. Having said that, stapling is expected to produce the following unintended impacts over time all of which are potentially negative to member outcomes:

- As the flow of new entrants to super funds becomes less automatic and more choice driven, insurers will likely lower the levels of automatic acceptance cover which are provided to members, including those members most in need.

- There remains a risk that unengaged (particularly young) members may be stapled to a fund that provides inadequate cover for their occupation.
- Because only a small number of specialist funds took advantage of the dangerous occupation exception in section 68AAF of the SIS Act allowing them to continue to provide default cover to new members under age 25 and with low balances, on moving into a high-risk occupation employees may be stapled to a fund that excludes such occupations from cover and so provides no cover to them.
- Stapling and more broadly increased levels of member choice will lessen the ability of funds and employers to provide insurance coverage tailored to income levels and occupation. We expect that super funds will likely drift toward the centre, having to provide for a broader range of members, leading to more generic default insurance designs that are less tailored to income and occupation.

We would be pleased to discuss this submission with you or to provide any further information required.

Yours sincerely

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