June 2019

Submission in Response to APRA Consultation Letter on Prudential Standard SPS 515

ABOUT US

Super Consumer Australia (Super Consumers), formerly known as the Superannuation Consumers' Centre, is an independent, not-for-profit consumer organisation formed in 2013. Super Consumers works to advance and protect the interests of low and middle income people in the Australian superannuation system.

We work in partnership with CHOICE; the consumer advocate that provides Australians with information and advice, free from commercial bias. CHOICE fights to hold industry and government accountable and achieve real change on the issues that matter most.

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Introduction

As the 2018 Productivity Commission Inquiry into Superannuation highlighted, Australia's superannuation system has failed to protect the interests of too many people. Poor fund performance has cost some members as much as $660,000[1] in savings that should have financed a comfortable retirement free of financial hardship. This is money that could have been spent on energy bills, food, healthcare and housing. The Financial Services Royal Commission brought attention to some superannuation funds have failed to act in their members' best interests by engaging in practices like charging advice fees for no service and employing inappropriate marketing tactics.

The revised standards are a crucial step in ensuring that superannuation funds prioritise consumers' needs and expectations. We strongly support the incorporation of consumer-focused objectives into funds' mandatory business strategies.

Too often trustees have been allowed to define their own success. This is often done through unambitious return targets or comparisons to benchmarks that are entirely inappropriate. It is time for APRA to take a more active role in setting robust, independent benchmarks for success. This needs to be complemented by APRA taking on a more active role in driving funds to improve performance or exit the market.

Ultimately many of the good consumer protections proposed in this standard could be undone if we don't see improvements to the default system and improved guidance for people electing to leave a default fund. The measures proposed in this standard will take years to have their full impact. Meanwhile, new employees continue to be defaulted into poor performing funds every day. Many are also leaving good performing default funds, lured by the attraction of secondary factors such as customer reward points or other short term incentives. This standard is a good

[1] Productivity Commission, 2018, Inquiry report - Superannuation: Assessing Efficiency and Competitiveness, p.11

step, but it is a slow way to solve many of the problems that have their roots in the failings of the default system.

We have identified several modifications that would make the standards more effective and powerful.

Summary of Recommendations

Recommendation 1: That APRA bring forward the first evaluation due date to the end of the 2019-2020 financial year.

Recommendation 2: That APRA require RSE licensees make summaries of all previous and current business performance reviews (BPRs) publicly available.

Recommendation 3: That the new comparative test in section 52(9) of the SIS act be harmonised with the “outcomes assessment” detailed in SPG516 in such a way that fees, returns, and risk are assessed against an objective benchmark.

Recommendation 4: That the standards be revised to clarify that the primary purpose of the BPR is to ensure member outcomes are met.

Recommendation 5: That the structure and content of the BPRs and public BPR summaries be standardised.

Recommendation 6: That APRA clarify its definitions of ‘appropriate’ and ‘independent’ expert.

Recommendation 7: That APRA create a consultant vetting process, barring superannuation funds from using ‘independent’ consultancy firms that have a demonstrated history of dishonest or unethical practices.

Recommendation 8: That APRA specify a “right to remain” test which requires the net return of a MySuper or choice product over a rolling eight year period not to underperform by more the 0.5 percentage points the return of a tailored (by asset allocation) benchmark portfolio. This benchmark portfolio should be constructed with listed indexes, as recommended by the Productivity Commission.

Recommendation 9: That APRA require underperforming funds to rectify their shortcomings within 1 year of receiving notice or face revocation of their MySuper license or direction to withdraw the underperforming choice investment option.

Recommendation 10: That APRA review the adequacy of the successor fund transfer process.

Recommendation 11: That APRA establish a set of mandatory cohorts which include but are not limited to gender, income, balance size and number and age of dependents.

Recommendation 12: That APRA mandate the design and implementation of a compulsory, standardised representative annual survey of fund members to assess levels of awareness and understanding of superannuation product features.

Business Performance Review (BPR)

Bring the due date forward

We have reservations about the proposed time frame for the implementation of the revised standards. We note that the Productivity Commission calls for **urgent reforms** given the high rates of poor management and fund underperformance.[2] Additionally, the report states that there is "considerable evidence of trustees acting in ways that are inconsistent with members' best interests."[3] This includes cases of excessive financial advice fees that drain account balances[4] and inappropriate marketing tactics designed to attract employers.[5]

It will take time for funds to identify and act on short comings. The new requirement that funds adjust their organisational strategies and business models to improve member outcomes must therefore be **implemented as a priority.** Yet the proposed standard will not commence until

[2] Productivity Commission, 2018, Inquiry report - Superannuation: Assessing Efficiency and Competitiveness, p.135

[3] Ibid, Finding 9.6, p. 62

[4] Ibid, p. 53

[5] Ibid , p. 24

January 2020, which is over 6 months away. Registrable Superannuation Entities (RSE) licensees will then have a further 12 months to submit their first Business Performance Review (BPRs), which are due on 31 December 2020. The underperforming tail of funds identified by the Productivity Commission collectively hold 5 million member accounts with $269 billion in assets[6] and being in a bottom quartile performing fund costs an average worker 13 years of lost pay, or $660,000.[7]

Superannuation consumers cannot afford another 18 months of inadequate performance. We urge APRA to bring forward the due date for the first reviews to **30 June 2020.**

Recommendation 1: That APRA bring forward the first evaluation due date to the end of the 2019-2020 financial year.

Make current and existing reviews public

The Banking Royal Commission and Productivity Commission reports demonstrated that people have been let down by the financial services industry. As outlined above, one of the most costly yet hidden let downs is the cost of being stuck in an underperforming fund. The Business Performance Review will detail how funds assess their performance and thus is valuable information for policy makers and the general public. It would be perverse if a test designed to ensure member outcomes are met is not publicly accessible to members.

In line with the requirement of section 52(9)(aa) of the SIS act that funds publish a report detailing their determination of whether they are promoting members financial interests, we recommend APRA mandate that funds **make summaries of all BPRs available on their websites**. The summaries should include all product level assessments of investment performance and insurance products, complete with cohort level analyses. These should be

6 Productivity Commission, 2018, Inquiry report - Superannuation: Assessing Efficiency and Competitiveness, p.10

7 Ibid, p.11

published online on an **ongoing, cumulative basis**. This would enable consumer groups and policy makers to track funds' performance over time and check that funds meet their obligations, and that these obligations consistently prioritise member outcomes.

> **Recommendation 2**: That APRA require RSE licensees make summaries of all previous and current Business Performance Reviews publicly available.

Clarify the interaction between components of the business performance review

It is important that consumer groups and policy makers are able to track the performance of funds over time, and check that funds meet their obligations and that these obligations consistently prioritise member outcomes. This will help people better evaluate whether their fund is right for them. This can be achieved by requiring that the Superannuation Industry (Supervision) Act 1993 **product comparison** test be incorporated into the "outcomes assessment".

Sub-section 14(a) in the draft standard, shown in figure 1, outlines three facets for measuring the achievement of strategic objectives: business plan Key Performance Indicators (KPIs), a holistic outcomes assessment and a related but distinct "financial outcomes" test which now forms part of the Superannuation Industry (Supervision) (SIS) Act:

(a) analysis of its performance in achieving its strategic objectives, having regard to:

- (i) the results of its monitoring of its business plan required under paragraph 12;
- (ii) the outcomes achieved for different cohorts of beneficiaries (such that all beneficiaries are covered), relative to the outcomes sought, and against objective benchmarks; and
- (iii) the outcomes assessment under section 52(9) of the SIS Act;

Figure 1 - APRA draft SPS515, section 14(a)

As there is substantial overlap between a(ii) and a(iii), it is in the interest of all parties to incorporate the SIS Act test requirement into the "outcomes assessment" detailed in SPG516. The act empowers APRA to expand the scope of the new comparative tests in subsections 9-11 of section 52 of the SIS Act. It can use this to harmonise the treatment of returns, fees and insurance between its BPR and the requirements under the Act. This has the substantial benefit of resolving how funds weight each subsection in their overall assessment of whether they are achieving the outcomes they seek for members, as per subsection 14(c)(i).

> **Recommendation 3**: That the new comparative test in section 52(9) of the SIS act be harmonised with the "outcomes assessment" detailed in SPG516 in such a way that fees, returns, and risk are assessed against an objective benchmark.

Put member outcomes front and center

Further, it would be useful to clarify the relationship between strategic objectives and member outcomes. Responses to the Productivity Commission have understandably focused on member outcomes, yet at present, achieving these outcomes is only a subset of achieving strategic objectives. The standards should be revised to clarify that the primary purpose of the BPR is to ensure member outcomes are met. It should be made abundantly clear that providing things like a high end app or trading interface in no way make up for a poor fund performance.

> **Recommendation 4**: That the standards be revised to clarify that the primary purpose of the BPR is to ensure member outcomes are met.

Standardise the BPR

The SPG516 document indicates funds will have flexibility regarding the precise structure and content of the BPR, however it is in members' best interests that the reviews be as standardised and transparent as possible. This would simplify the process of identifying poor performance and make it easier for APRA to issue appropriate directions. Assuming that BPR summaries are released, these should also be standardised to allow for easier comparison for consumers and third parties that provide information about fund performance.

Recommendation 5: That the structure and content of the BPRs and public BPR summaries be standardised.

Clarify vetting process of independent experts

> **"**16. *APRA may require an RSE licensee, by notice in writing, to appoint an appropriate independent expert to provide to APRA a report on a particular aspect of an RSE licensee's business performance review, within a time frame agreed to by APRA. An RSE licensee must bear the costs of such an appointmen*t."
> Draft SPS 515 (2018), p. 4

We strongly support APRA's power to require an RSE licensee to "appoint an appropriate independent expert" to provide a report on the licensee's BPR. There was clear evidence in the Banking Royal Commission of AMP executives altering what was meant to be an independent report from law firm Clayton Utz.[8] It is unfortunate it has come to this, but in order to restore trust we need measures to ensure this kind of reporting is indeed independent.

We need to develop robust definitions of 'appropriate' and 'independent' to prevent misunderstandings or further dishonesty. APRA should make it clear that independent reviews should not be edited or unduly influenced by management. APRA also needs to create a vetting process, barring superannuation funds from using 'independent' consultancy firms that have a demonstrated history of dishonest or unethical practice. Overall we want to see APRA taking an active role in ensuring superannuation funds are appointing suitable experts to provide these reports.

[8] ABC News, "ASIC challenges AMP, Clayton Utz on documents relating to fees-for-no-service scandal", December, December 17, 2018

Recommendation 6: That APRA clarify its definitions of 'appropriate' and 'independent' expert.

Recommendation 7: That APRA create a consultant vetting process, barring superannuation funds from using 'independent' consultancy firms that have a demonstrated history of dishonest or unethical practices.

Investment Performance

The standard currently lists two components of the investment performance review: section 14(a)(ii), which asks for a cohort level analysis of outcomes, and 14(a)(iii), which incorporates the promotion of financial interests test in 52(9) of the SIS Act. Both SPG516 and the legislated test respectively expect or require returns comparisons at product level. Both also direct funds to compare their product returns against the appropriate competition and benchmarks. These two sections may be **fruitfully combined** into a **single, semi-standardised investment performance analysis** that can be used across the industry. This would provide clarity and focus for trustees, reducing the scope for cherry-picking metrics and inappropriately weighting less important outcomes.

Compare net returns with tailored benchmark portfolio

The appropriate standard for evaluating investment returns to beneficiaries, as used in the Productivity Commission inquiry report[9] and legislated in the section 52(9) test for MySuper products, is net of all fees, costs and taxes.[10] We note that this net of everything requirement is not specified for choice products for the comparative test but is specified for all regulated funds in section 52(12). Using "net of everything" returns is important to reflect and allow comparison of the return on investment that beneficiaries actually receive. The comparison of long term net

[9] Productivity Commission, 2018, 'Superannuation: Assessing Efficiency and Competitiveness, Inquiry Report no. 91, Technical Supplement 4', p. 17-18

[10] SIS Act, section 52(9)(a)

returns with the return on a benchmark portfolio tailored to the asset allocation of the product being offered using listed indexes would be an effective "kill-switch" for persistently poorly performing products.[11]

This approach is sufficiently flexible to accommodate all MySuper products and the majority of choice product options. It is also difficult to game, provided that APRA gives clear guidance on the appropriate indexes for different asset classes, and sets a universal standard for underperformance relative to the tailored benchmark. Without this approach we are not comparing apples with apples. There is a real potential that underperformance will be hidden by other, less appropriate, relative measures.

Form of appropriate benchmark and necessity of using historical data

The Productivity Commission recommended that all MySuper and choice products be subjected to elevated outcomes tests in order to earn the 'right to remain' in the system.[12] It also recommended that products fail the "right to remain test" if they underperform relative to their tailored benchmark by at least 0.5 percentage points over an 8 year period. The 0.5 percentage point buffer reflects the uncertainty inherent in creating a counter-factual investment opportunity, in terms of the appropriate indexes, level of fees, costs and taxes to apply.

The Productivity Commission work in this area is an important point of reference for APRA when determining what an appropriate benchmark would be. The eight year period allows for the effects of short term market volatility. Additionally, it mitigates potential issues with funds choosing unsustainable, short term strategies because they initially generate better returns. The eight year period also prevents funds from shying away from choosing investments that differ from those that constitute the market indexes.

In assessing their long term performance, funds should be **required** to use all available, high quality historical data to allow the benchmarking to become applicable as soon as possible. We

[11] Productivity Commission, 2018, 'Superannuation: Assessing Efficiency and Competitiveness', p.588
[12] Ibid, 37

support the Productivity Commission's conclusion that the benchmark should be fully implemented by 2022. By this point, APRA will have collected eight years of high quality data.

Recommendation 8: That APRA specify a "right to remain" test which requires the net return of a MySuper or choice product over a rolling eight year period not to underperform by more the 0.5 percentage points the return of a tailored (by asset allocation) benchmark portfolio. This benchmark portfolio should be constructed with listed indexes, as recommended by the Productivity Commission.

Inadequacy of target returns as a performance benchmark

Section 24 of SPG516 mentions the use of funds' return targets as a measure of their investment performance. This is unlikely to be an effective measure to combat persistent underperformance. When the Productivity Commission assessed performance in the MySuper segment using APRA data, they found that 38 of 96 products underperformed a benchmark portfolio return that was tailored according to asset allocation at product level.[13] A benchmark composed of the average allocation for the segment yielded similar results, with 27 underperformers. However, when comparing products to the median *target* return as put forward by funds, **no fund underperformed this benchmark**.[14]

In general, funds are unlikely to set stringent targets for themselves given the potential risk of not meeting them. A very real contributor to underperformance has been the continued freedom funds have been given to set their own performance measures. Real lifts in performance are only going to come from **establishing independent rigorous performance benchmarks**.

For new products, an alternative metric would be comparison with other products with similar levels of risk and asset allocation within the same segment. One drawback is that in many cases this would result in small sample sizes. If the products perform poorly as a group, this method will also not effectively deal with underperformance at a system level. Thus this type of

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[13] Productivity Commission, 2018, 'Overview - Inquiry report - Superannuation: Assessing Efficiency and Competitiveness', p.140

[14] Productivity Commission, 2018, 'Superannuation: Assessing Efficiency and Competitiveness', p.140

comparative analysis should be secondary to a tailored benchmark approach. Nevertheless, this type of analysis is necessary during the period where longer term metrics are not yet applicable for a product due to its recent inception. One potential solution is that **funds be subject to guidance from APRA** if they consistently underperform the median net return achieved by other comparable products as well as their tailored benchmark for several years following their inception. A product which is underperforming both its competition and a passive index version of itself is unlikely to be promoting members' financial interests, even given the distortions of short run market volatility.

Consequences of long term underperformance

As recommended by the Productivity Commission and echoed by SPG516, the long term underperformance of a product should trigger a process of remediation in which the fund would assess whether it can feasibly improve performance within a reasonable timeframe.

Given the consumer harm caused by persistent fund underperformance, we strongly support the one year deadline recommended by the Productivity Commission. A short time frame would drive funds to quickly solve the underlying problems in their fund. Quick steps could include cutting high fees, as the Productivity Commission found that funds with above average fees "typically do not deliver higher net returns".[15]

In the event that a product fails to return to meeting its long term benchmark within a year, we recommend that **APRA revoke the fund's MySuper authorisation**, or direct it to withdraw the choice investment option. A fund which has exhibited long term underperformance has done substantial harm to its members' retirement prospects. If it cannot demonstrate improved performance within a reasonable timeframe, it is in the members' best interests to be moved into a different product. In this regard, if another suitable product cannot be found within the same fund, APRA must ensure that the fund nominates a suitable recipient fund for the members of the underperforming product, and that those members are no worse off.

[15] Ibid, p.154

Recommendation 9: That APRA require underperforming funds to rectify their shortcomings within 1 year of receiving notice or face revocation of their MySuper license or direction to withdraw the underperforming Choice investment option.

Successor fund transfers

As the new standard applies more pressure for under performing fund to merge, APRA needs to pay close attention to how the successor fund transfer process operates. There is a risk that some funds have invested so heavily in poor performing assets that they would represent a liability to any fund considering merging with them. It would be a terrible outcome if members were left to languish in an underperforming fund because no merger partner could be found. This problem is made worse by the current default allocation system, which pays limited regard to the performance of the funds into which people are being defaulted. The default system exacerbates the problem by continuing to grow the size of poor performers, potentially making mergers more difficult.

Any solution to this problem needs to include improvements to the default system It is clear that without reform to the default system, underperformers will continue to hold a large volume of funds in underperforming assets. There is an **urgent need** for the Federal Government to reform the default system to stop people continuing to be defaulted or making poorly informed decisions to join underperformers. In the meantime we recommend APRA review the impact of increased merger pressure on the successor fund transfer process.

Recommendation 10: That APRA review the adequacy of the successor fund transfer process.

Insurance Products

There are **two key questions** for insurance products in superannuation:

The first is whether insurance policies, especially those offered by default in MySuper products (Death, Income Protection and Total and Permanent Disability), are appropriate for the beneficiaries of the product as a whole, as well as for specific cohorts (e.g. low income and intermittent workers). In considering this, excessive balance erosion is the most important issue.

The second question is whether the insurance policies offer value for money, both overall and when compared with similar policies offered in comparable superannuation products. Considering value will require analysis on whether policies are both affordable but also whether they offer quality of cover for members.

Suitable cohort analysis

The Productivity Commission found that for workers with death and Total and Permanent Disability (TPD) insurance, premiums erode retirement balances for a representative worker by 4% or $35,000.[16] This figure rises to 5.6% for a low income worker or a worker with intermittent work history and up to 6.9% or $69,000 for a worker who also holds an income protection (IP) policy, which is the case for 29% of MySuper accounts.[17] For a low income blue collar worker with IP insurance, this figure climbs to a hefty 13.6% or $85,000.

We strongly recommend that APRA specify a cohort analysis that takes into account the detrimental impact inappropriate insurance products have on members. APRA can facilitate this by **mandating that funds review the suitability of each type of insurance cover their product offers.** These evaluations should at minimum consider income level, balance size, number of dependents, gender, occupation classification and work history (to identify intermittent workers).

Industry has already been given ample opportunity to self-define how it meets the needs of individual cohorts through the Life Insurance in Superannuation Voluntary Code of Practice.

[16] Productivity Commission, 2018, 'Superannuation: Assessing Efficiency and Competitiveness', p.379

[17] Ibid, p.369

However, the entire code is on an 'if not why not basis', without adequate oversight. This has meant funds are free to ignore the code and of the needs of individual cohorts in insurance design. This continues to lead to poor outcomes, particularly for younger people, women and those with low balances who are often forced into levels of insurance cover well above their needs or means. APRA needs to establish a minimum set of cohorts that funds would be required to report against, these should include factors such as gender, income, balance size, work history and number and age of dependents.

Recommendation 11: That APRA establish a set of mandatory cohorts which include demographic factors such as gender, income, balance size and number and age of dependents. These cohorts should be used by funds to assess insurance offerings as well as overall product design.

Member Services, Engagement and Education

SPG516 indicates that member services should form a weighted component of the outcomes assessment. There is great scope for funds to commit to better educating and engaging with members, especially given that the Productivity Commission survey found almost a quarter of respondents couldn't say if they even had life insurance included in their superannuation product.[18] In order to assess whether funds are succeeding in their efforts, a universal metric would greatly aid regulators and funds themselves assess their success.

Universal metric for member engagement and education

We propose a compulsory, standardised, representative annual survey of member understanding of the characteristics of their superannuation product. Independent experts should design the proposed survey to be as informative as possible. However funds would be free to administer it in a manner best suited to their membership.

[18] Productivity Commission, 2018, 'Superannuation: Assessing Efficiency and Competitiveness', p. 259

Such data would be useful in the following ways:

- It would provide a universal metric for evaluating funds' efforts to educate and engage with their members,
- It would provide a recurring prompt for members to engage with their superannuation.
- It would shed light on the areas in which education and engagement initiatives are needed most.

The data would both inform the outcomes assessment and be reported directly to APRA in order for it to better assess the funds' efforts.

Recommendation 12: That APRA mandate the design and implementation of a compulsory, standardised representative annual survey of fund members which assesses their degree of awareness and understanding of the features of their superannuation product.