HESTA | An Industry SuperFund

Your Future Your Super review submission - October 2022

HESTA welcomes the opportunity to make a submission to Treasury's review of implementation issues and unintended consequences arising from the *Treasury Laws Amendment (Your Future, Your Super) Act 2021*.

HESTA members

HESTA is an industry super fund with $68 billion of assets under management on behalf of more than 950,000 members who work primarily in the health and community services sectors. Our largest member cohort works in aged care.

Eighty per cent of our members are women, and most are on low-to-middle incomes. They earn less than their male counterparts on average, are less likely to be able to save outside their super, and are more likely to struggle to meet day-to-day expenses. Many of our members spend time in unpaid care work, which adds enormous economic benefit to the country at the expense of their own financial security.

We seek to ensure that our members' experiences are considered in complex policy deliberations that impact their financial security in retirement.

Background

HESTA continues to support the policy intent of the Your Future, Your Super package in line with our previous submissions. It is of central importance that our superannuation system delivers the best possible financial outcomes for members. We support achieving this through systemic protections, which are the most effective way to maximise member outcomes.

HESTA welcomes this review as an opportunity to improve elements of the package that are not delivering their objectives, risking unintended outcomes for members and impacting the effective operation of our superannuation system. We support further consideration being given to all areas of the package to improve the extent to which it delivers on its policy intent.

Recommendations

Performance Test

1. Performance test methodology should be redesigned to assess overall member outcomes using an industry standard measure relevant to the product
2. If the preferred approach of redesigning the test methodology is not taken up, a second stage analysis which takes into account a range of factors including the trustee's approach to managing risk, should be applied where products fail the initial test or only pass by a small margin
3. Develop a methodology for measuring climate-adjusted performance and apply this as a consideration during the second stage analysis
4. If the preferred approach of redesigning the test methodology is not taken up, improvements should be made to benchmarks based on ongoing industry consultation and review
5. Performance should be measured over a rolling 10-year timeframe to better align the test with long-term investment horizons and reduce unintended consequences
6. Use actual administration fees over time to align more closely with member outcomes

Comparison Tool

7. Rank products based on highest to lowest net return, not fees
8. Include information on the value of insurance
9. Publish performance test outcomes based on improvements to the performance test
10. Enable members to compare a choice product against a MySuper product

Best Financial Interests

11. Remove the reverse onus of proof
12. Provide guidance on record keeping obligations

Stapling

13. Require that a stapled fund is a fund that has passed the performance test
14. Consider the impact of stapling on default insurance arrangements

Performance test

HESTA remains consistent in our support for robust performance testing. Australia's superannuation system settings must protect members from underperforming products.

HESTA's MySuper product, Balanced Growth, has performed well against the performance test to date.

HESTA has consistently raised concerns that the methodology of the current test doesn't appropriately identify persistent under performance, or measure the value delivered to members. Further, it risks driving unintended consequences in investment decisions, reducing net returns and stifling investment innovation to meet emerging capital needs and opportunities.

Unintended consequences

Risk of reduced member outcomes

According to the consultation paper, the purpose of the performance test is "holding trustees to account for the investment performance they deliver". The policy objective is sound, but the test's methodology is insufficient to measure overall value delivered to members. Currently the performance test only measures a trustee's ability to implement their long-term investment strategy, rather than the quality of the strategy in achieving member outcomes. Trustees drive outcomes by:

- Setting strategic asset allocation (SAA) to meet investment objectives;
- deviating from the SAA to manage certain short and medium-term conditions;
- employing active management within asset classes; and
- managing operational drift.

The failure of the test to account for the way in which trustees deliver value beyond executing against their SAA, means that funds that are labelled underperforming may provide better outcomes than funds that are labelled performing and vice-versa. Whether underperformance is persistent is also not adequately established by the current approach.

The limitations of the test, combined with the significant consequences of failing the test, also has the potential to drive reduced member outcomes. To reduce the probability of failing the test, trustees have cause to de-risk the investment strategy against the test benchmarks. For example, trustees are disincentivised from taking a defensive tilt relative to SAA during nearer-term periods of stress due to the risk of short-term underperformance.

These issues are compounded where the benchmarks, and/or the timeframe for testing, are misaligned with the risk and return profile and longevity of investments in certain asset classes, and where trustees are managing long-term, forward-looking portfolio risks.

Systemic liquidity risks

By encouraging all superannuation funds to adopt its standardised benchmarks, the test pushes a significant concentration of capital into managing the same pre-determined 'active risk' exposures. This could see concentrated liquidity risks should these indices change, or market events require repositioning.

Further, there is a risk that publicity around failing the test could cause a 'run' on a fund. Although members have generally not switched out of underperforming products to date, it is possible that as engagement increases more members may react to a performance test failure notification. Given most funds contain a level of illiquidity, a capital flight could create significant liquidity risks, and further disadvantage the remaining less active members who are already disadvantaged by the closure of the product to new members.

A challenge for managing climate risk in portfolios

A testing methodology that discounts the benefit of risk management is particularly problematic where funds are meeting their obligation to manage long-term risks like climate-related financial risk across their portfolio.

This issue is not limited to specialist Environmental, Social, Governance products, though they are particularly impacted. As large and diversified asset owners, superannuation funds cannot simply diversify away from climate-related risks. All investment options will be impacted by the transition of the global economy to a low carbon future, and it is both a regulatory obligation, and in the best financial interests of our members to manage systemic climate risk in our portfolio.

In addition to active ownership, management of climate risk may require the use of portfolio tilts and/or exclusions away from companies with large residual climate risks, as well as long-term investment in new technologies to support the climate transition. These approaches deliver long-term financial benefits to superannuation fund members, but in the short-term may also create a risk profile that deviates from current fossil fuel exposed performance test benchmarks.

The impact on innovation to meet emerging opportunities

Investing in unlisted markets allows HESTA to access investments that offer inflation-protection, diversification and an illiquidity risk premium. These investments are well suited to patient super fund capital, delivering value for members over the long-term. A secondary benefit of these investments is that they support economic growth, providing capital for key needs such as social, energy and transport infrastructure.

However, the varied nature of risk and return profiles for these assets, and difference in volatility against their benchmarks, can be a disincentive to investment. This has direct implications for both member outcomes and for the allocation of capital to support Australia's capital investment needs. Some examples include:

- The benchmark for unlisted property is dominated by the office and retail sectors, with no exposure to the emerging institutional residential property sector, providing a disincentive for trustees looking to innovate for investment in residential housing, including the affordable housing sector.
- The benchmarks for unlisted infrastructure are typically concentrated both in terms of asset sectors and managers that submit information. Typically, higher growth/higher risk 'GDP linked' assets comprise around 60% of the benchmark, disadvantaging lower risk/return 'regulated' or 'contracted' assets. The unfrozen nature of the index also means historical index data can change retrospectively, causing ongoing uncertainty.
- Unlisted assets, and private equity investments in particular, tend to be long-term in nature, a profile that is misaligned with the duration of the performance test, despite being strongly aligned with the fundamental purpose of superannuation.
- New strategies may not have typical risk-return profiles, creating issues with benchmark comparisons as funds innovate to meet emerging opportunities.

Investment in climate solutions, new approaches to the supply of affordable housing, and other economy-supporting assets present an opportunity to innovate for strong economic and investment outcomes now and into the future. It is important that policy settings enable this innovation.

Reducing unintended consequences

Improving the performance test

The performance test methodology should be redesigned so that it more accurately measures overall member outcomes. This can be achieved using an industry standard measure relevant to the product – either peer relative performance or a relevant simple

reference portfolio would give an assessment of the overall value delivered by the trustee and reduce the unintended consequences resulting from trustees managing outcomes against asset class benchmarks.

If the test is not redesigned, a second stage of analysis should be applied where a product fails the initial test, or where a product passes by a small margin. Whether underperformance is persistent could be confirmed by assessing the investment strategy and capability of the trustee. It is important that the trustee's approach to risk management is part of this assessment, with consideration given to risk adjusted returns and historic volatility.

Considering where the product is sitting against peers over the long-term and across different time horizons would identify those that have struggled to be competitive over long periods, confirming underperformance is persistent and not based on temporary factors. This will avoid, for example, the test capturing products with poor historic performance that undergo significant changes to improve their recent investment outcomes, or products that may have consistently poor performance on a peer relative basis that haven't failed the test. Labelling products as underperforming should occur when the second stage of analysis has confirmed that underperformance is persistent.

Importantly, an approach for considering climate-adjusted performance should be developed in consultation with the superannuation sector and consideration of this should be included in the second stage of assessment.

A more appropriate timeframe

Extending the timeframe of the test to a rolling 10-year period would align with the MySuper performance objective timeframe and better reflect contemporary understanding of market cycles. To achieve a rolling ten-year period and to avoid further retrospective application, each of the additional years should be progressively added to the timeframe until 10 years of performance data is reached.

Improvements to benchmarks

If the test is not redesigned to measure overall member outcomes, consultation should be undertaken on improvements to the performance test benchmarks. Benchmarks should then be subject to ongoing review by the regulator in consultation with the superannuation industry.

Pressing improvements include addressing unintended consequences arising from the current benchmarks for unlisted assets. For example, issues with the unlisted

infrastructure benchmark may be reduced by moving to an industry standard CPI + benchmark, or an alternate index such as EDHEC, while private equity investments could be better assessed against an unlisted benchmark.

Another improvement would be an increase in the granularity of benchmark coverage, noting that the APRA reporting form 533 is starting to capture this level of information. For example, rather than using a broad international equities index, the approach captures the split between developed and emerging markets. This could also include target bond benchmarks and carbon-aware benchmarks, along with improved proxies for alternative assets such as cash plus objective. Further, introducing self-selected global benchmarks to match portfolio exposures would be valuable.

The ability to update the benchmark allocations through time, reflecting portfolio holdings, rather than only aligned with the annual investment strategy review process, would also improve the approach.

Actual fee outcomes

The administration fee methodology should be changed to use actual administration fees charged over the period of the performance test. The use of current administration fees creates perverse incentives. Reducing relative administration fees by 1bps for the year, has the same impact on the performance test outcome as producing 8bps of outperformance. It runs the risk of encouraging behaviours whereby cost management strategies might be undertaken to 'game' the net outcome. Moving to actual annual administration fees reduces this risk and improves the extent to which the test reflects member outcomes, while still providing downward pressure on fees.

Recommendations

1. **Performance test methodology should be redesigned to assess overall member outcomes using an industry standard measure relevant to the product**
2. **If the preferred approach of redesigning the test methodology is not taken up, a second stage analysis taking into account a range of factors including the trustee's approach to managing risk, should be applied where products fail the initial test or only pass by a small margin**
3. **Develop a methodology for measuring climate-adjusted performance and apply this as a consideration during the second stage analysis**

4. **If the preferred approach of redesigning the test methodology is not taken up, improvements should be made to benchmarks based on ongoing industry consultation and review**
5. **Performance should be measured over a rolling 10-year timeframe to better align the test with long-term investment horizons and reduce unintended consequences**
6. **Use actual administration fees over time to align more closely with member outcomes**

Comparison tool

HESTA supports the availability of a publicly accessible tool that provides the ability to compare the performance of superannuation products. However, the current YourSuper comparison tool has some limitations which may result in less-than-optimal decision-making.

- The tool defaults to ranking products based on annual fees rather than net returns. This risks decisions being made on a metric that isn't necessarily aligned with strong overall performance. Products should be ranked highest to lowest based on net returns.
- The value of insurance is not included in the tool. This is of particular concern for members in hazardous occupations who may not be aware of the value of the insurance they have in their workplace default product. The tool should make this clear.
- Risk is not included in the tool, so users are not necessarily considering a like-for-like comparison.

As a first principle, it is important that the tool is not misleading, and so these issues should be resolved. Metrics should be brought in line with changes to the performance test made as a result of this review, including around the lengthened timeframe.

Finally, without impacting the simplicity of the MySuper comparison, the tool (or an additional tool) should allow users to compare a MySuper product with a choice product. Members must have a basis for making a decision to leave a default fund and enter a choice product.

Recommendations

1. **Rank products based on highest to lowest net return, not fees**
2. **Include information of the value of insurance**
3. **Publish performance test outcomes based on improvements to the performance test**
4. **Enable members to compare a choice product against a MySuper product**

Best Financial Interests Duty

HESTA supports measures that encourage strong governance frameworks around expenditure and investments. The decisions trustees make in respect of members' money must be in the best financial interests of members and must be supported by appropriate record keeping requirements that enhance accountability and transparency.

HESTA has always interpreted the best interests duty to be one of best financial interests. Prior to the introduction of the Best Financial Interests Duty (BFID), HESTA had well established and robust governance frameworks to help meet its obligations under the law to act in members' best interests.

Strong governance frameworks allow for appropriate monitoring and assessment of expenditure, and we continue to be supportive of the principles behind BFID.

To further support compliance with the BFID regime and ensure members' money is protected, we believe enhancements could be made that would make the measures more effective.

Reverse onus of proof

We are supportive of the views outlined in their submissions by the Australian Institute of Superannuation Trustees (AIST) and The Association of Superannuation Funds of Australia (ASFA). We highlight that the presumption that a trustee is in breach of its duties is a departure from common law and do not believe that the imposition of this evidentiary burden on trustees is proportionate or reasonable. We recommend this obligation, which is unique to superannuation in the financial services landscape, should be removed.

Guidance

The existing regime, with its accompanying reverse onus of proof, lacks guidance as to how best trustees can prove a proper discharge of their duties. While we have well

established processes that capture expenditure, we believe guidance around record keeping would enhance the effectiveness of the regime. Guidance would provide several benefits by streamlining how trustees record their expenditure as part of their broader strategy, which may involve expenditure that is necessary to the day-to-day operation and implementation of that strategy.

Furthermore, the resulting streamlining of how the record keeping obligations are met will benefit members by allowing them to more accurately compare funds' expenditures, make informed decisions about their fund, and support regulatory supervision activity by introducing consistency in how trustees record expenditure.

Recommendations
1. **Provide guidance on record keeping obligations** 2. **Remove the reverse burden of proof**

Stapling

HESTA continues to support the policy intent of ensuring members' account balances are not eroded by unnecessary administration fees due to unintended multiple accounts. However, issues with the design and implementation of stapling have led to poor member outcomes.

So that stapling achieves its stated policy intent without risking member outcomes, we believe that the review must consider the following elements:

- The definition of a stapled fund must include a fund that has passed the performance test so that members are not stapled to an underperforming fund; and
- The impact of stapling on default insurance arrangements.

Furthermore, there is an alternative model that we believe would better address the policy intent behind stapling while minimising the unintended consequences of the current mechanism.

This model would ensure the non-proliferation of multiple accounts based on the automatic rollover of balances, where a member would be stapled to their balance instead of a fund and their balance is rolled over automatically to their new account when they join a new employer or fund. This ensures the balance follows the member and ensures it is allocated to the fund most appropriate for their industry.

Underperformance

Stapling was introduced without sequencing, meaning it was introduced without first addressing underperformance. This has created a situation in which members of underperforming funds can be stapled to those funds.

This is evident based on the last two performance tests. Across FY2021 and FY2022, 14 MySuper products failed (13 in 2021 and five in 2022, with four of those five failing the test in two consecutive years), covering close to 1.1 million accounts of which over 550,000 were in the four products that failed the test for two years in a row[3].

Members holding accounts in underperforming products and who move jobs are more likely to be worse off at retirement if they remain stapled to their fund rather than getting the opportunity to default to a better performing fund. This risk is heightened by low member engagement in respect of their underperforming fund, evidenced by the low proportion of members moving their money out of poor performing products – only 7% of all the accounts in failed products, according to APRA[4].

The intention of reducing unintended multiple accounts is worthy and we support the principle behind this. However, the way stapling was designed and implemented did not account for the risk associated with poor performance and the final legislation and accompanying regulations did not require a stapled fund to be a fund that has not been labelled underperforming.

Requiring the definition of a stapled fund to include that the fund has passed the performance test protects members and minimises the likelihood of members remaining in an underperforming fund.

Insurance

HESTA has previously raised the risks associated with stapling in relation to insurance cover, and these concerns are still relevant.

The existing regime risks new entrants to the workforce of being stapled to a product with default insurance features that may not be appropriate later in their working life. For example, under the current stapling provisions a member who enters the workforce into a low-risk industry, such as retail, and later moves into a higher risk industry, such as the health care sector, would be stapled to a product that is unlikely to have an insurance component that is appropriate for them.

Because it appears that stapling did not fully take into consideration the impact of the Putting Members' Interests First (PMIF) package implemented in 2020, other risks arise in relation to default insurance arrangements.

Members who are under 25 years of age and have an account balance under $6,000 and who opted out of insurance because their circumstances did not require them to take up insurance cover may never get the opportunity later in life to obtain default cover if they remain stapled to their fund.

It is crucial that the stapling measures be considered in the context of these risks.

Recommendations

1. **Require that a stapled fund is a fund that has passed the performance test**
2. **Consider the impact of stapling on default insurance**