GRATTAN Institute

The superannuation performance test is performing – let’s keep it that way

Submission to the Treasury Review of the Your Future, Your Super performance test

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Overview

We welcome the opportunity to contribute to the review of the *Your Future, Your Super* performance test.

Superannuation is compulsory, complicated, and has a long-term payoff. The conditions for market failure are obvious. It is inevitable that most super fund members will not be engaged with their super and many won't make good decisions even when they are.

The Productivity Commission's 2018 inquiry into superannuation system performance found that fees were too high, there were too many funds, and that many members were left languishing in serially under-performing funds. The *Your Future, Your Super* performance test was designed to tackle these problems by implementing a key recommendation from the Productivity Commission inquiry.

Super funds are now required to notify their members if the fund falls further than 0.5 percentage points under a combined administration fee and net investment return benchmark over 10 years. Funds that fail the test for two consecutive years are not able to accept new members until their performance improves.

The performance test has led to better results for super fund members, with most under-performing funds merging with better-performing ones, and other funds lowering their fees. Members of super funds that failed the first round of the test in 2021 have since had a 20 per cent cut in the fees they pay, saving them more than $100 million in fees. The objective nature of the test was critical to achieving these benefits and must be protected.

In order to protect these benefits, there should be a high bar for change. The potential for unintended consequences alone does not justify policy change. There is no clear winner among the field of alternative methods – all have their wrinkles. In the absence of compelling evidence that a new method would achieve the same or better results for members, the government should retain the status quo.

Further, the test should continue to strive for broad coverage. The expansion into the choice sector in 2023 was the right call – choice is where the worst under-performance and highest fees are found.

Calls for carve-outs for specific environmental, social, and governance (ESG) investments do not appear to be based on compelling evidence. In the absence of evidence demonstrating a material deleterious impact, no special accommodations should be made.

The super industry would prefer to be left alone, or to have the opportunity to convince the regulator that it shouldn't have to change. But too many Australians have already suffered poor outcomes in superannuation for far too long. Maintaining the integrity of the *Your Future, Your Super* performance test will help ensure fewer Australians suffer that fate in future.

Yet more work still needs to be done. In particular, the superannuation system needs a wholesale competitive process for default status. The government's focus should be on implementing the remaining Productivity Commission recommendations, including the 'best-in-show' process for selecting default funds.

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1 The performance test is making consumers better off

1.1 Most fund members need protection

Superannuation is compulsory, complicated, and has a long-term payoff. It is inevitable that most working Australians won't engage with their superannuation, and many won't make good choices even when they do.

The 2010 Super System Review (the 'Cooper Review') and the 2018 Productivity Commission inquiry both concluded that about 60 per cent of members are disengaged and make no active choices.[1] This amounts to more than 10 million Australians who are particularly vulnerable to poor outcomes in the absence of effective policy interventions.[2] Even for those who do get engaged, the complexity of the system makes high-quality decision-making difficult.

Intervention is clearly justified. In its 2018 inquiry into the super system, the Productivity Commission argued that 'the first line of defence is and should always be the policy settings'.[3]

The evidence suggests policy has historically been inadequate and the effects of widespread disengagement are pronounced. Australians spend more than $30 billion a year on super fees – more than they spend on energy bills.[4] The Productivity Commission found that fees were too high and there was a long tail of under-performing funds.[5]

The performance test follows from a Productivity Commission recommendation and aims to protect members from under-performing funds. Any changes to the test must not undermine this objective.

1. Cooper (2010, p. 9); and Productivity Commission (2018, p. 260).
2. ATO (2024).
3. Productivity Commission (2018, p. 30).
4. Treasury (2020).
5. Productivity Commission (2018).

1.2 The test is delivering benefits

Treasury estimated that the performance test could reap $10.7 billion in benefits over the subsequent decade through under-performing funds improving or exiting.[6]

From October 2020 (just before the performance test was announced) to December 2023, the number of MySuper products fell by 28, from 88 to 60.[7] As at late 2022, of the 13 MySuper products that failed the first test in August 2021, 11 had merged into a better performing fund, with the remainder reducing their fees.[8]

As at June 2022, members of the products that failed the first round of the test in 2021 were paying fees at least 20 per cent lower than before the test was announced (see Figure 1.1). This represents a fee saving to those members of more than $100 million – and probably many more millions of dollars over subsequent years.[9]

For a young worker starting out their career in an under-performing fund, the lower fees they now pay will translate into a $25,000 boost to the super balance by the time they retire.[10]

These outcomes represent real benefits to members. A leaner system with fewer, lower-fee, and better-performing funds means higher balances at retirement. The Productivity Commission estimated that

6. Treasury (2020, p. 11).
7. APRA (2024).
8. Coates and Moloney (2022, Table 1.1).
9. These members would have also benefited from better investment performance from successor funds.
10. Cameo modelling based on a worker at aged 30 earning the median Australian wage of $67,000 a year who retires at age 67, assuming real wage growth of 1 per cent a year and returns before tax and fees of 7.5 per cent.

if the 50 highest-cost funds merged with the 10 lowest-cost funds, the annual savings would be about $1.8 billion.[11]

1.3 There is more to do to fix super

Australians have suffered poor outcomes in superannuation for too long. The performance test represents just one of several steps needed to fix these problems.

In particular, implementing the Productivity Commission's 'best-in-show' recommendation would inject broader, wholesale competitive pressure into the system.

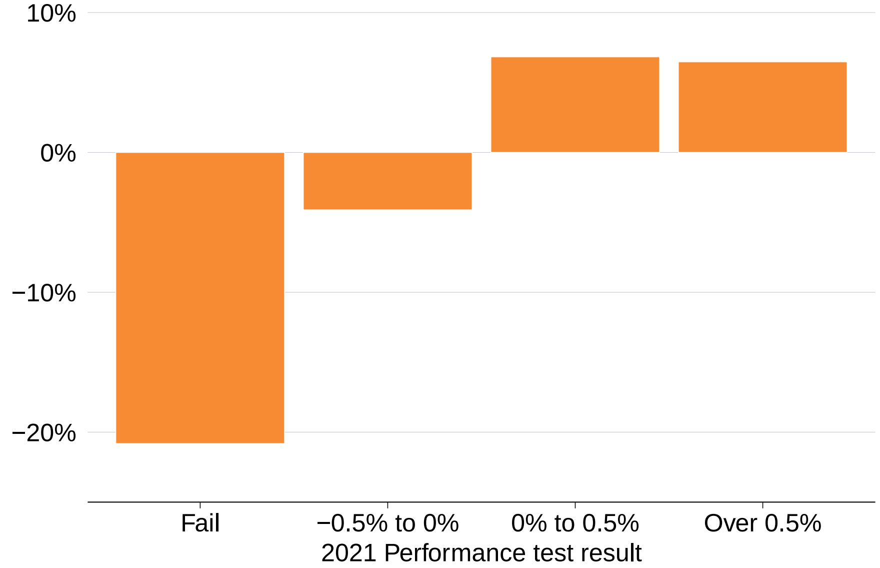
Under the Commission's recommendation, new workforce entrants would be defaulted into one of a short-list of 'best-in-show' funds selected by independent experts (although people would retain the right to choose another fund). 'Best-in-show' would improve returns because funds would compete to make the shortlist and stay on it.

Market discipline would come from experts who have the time, resources, and expertise to decide which funds to shortlist, rather than individuals who don't.

The government's focus should be on implementing the remaining Productivity Commission recommendations, rather than tinkering with those already implemented.

Figure 1.1: Members in products that failed or nearly failed are paying lower fees

Percentage change in average fees for a representative $50,000 balance member from September 2020 to June 2022, by 2021 performance test result



Notes: Fees include administration and investment fees. Asset-weighted average uses assets as at September 2020. This period includes the transition to the new fee disclosure regime, RG97. It is difficult to unpick the effect of this, but the averages across these broad groups are likely to be indicative of 'true' fee changes. Excludes the four products not tested in 2021, and products that passed but did not have a performance test metric reported in the 2021 Heatmap. Products that have merged since September 2020 are matched to the June 2022 fees now charged by the receiving product, to reflect the fees paid by members. Mergers planned but not yet completed as at June 2022 are not factored in.

Source: Grattan analysis of APRA (2022) and APRA (2021a).

11. Productivity Commission (2018, p. 355).

2 There should be a high bar for change

The broad framework of tailored benchmark portfolios and peer-group administration fee benchmarking is the best available, and came after many years of consultation by the Productivity Commission, APRA, and Treasury.[12]

Any move away from this framework should be based on compelling evidence that it will produce better results for super fund members.

2.1 Any changes must not undermine the tests benefits

Consistent with the principles outlined in the consultation paper for this review, any change to the test must factor in the impact on the test's substantial benefits (outlined in Chapter 1 of this submission).[13]

The potential for unintended consequences alone does not justify policy change. Their magnitude matters too. A change that ameliorates a minor unintended consequence but materially weakens the test will not be in members' interests.

2.2 The objectivity of the test must be retained

The consultation paper correctly emphasised the need to retain the objectivity of the performance test.[14]

The existing test provides a clear and transparent benchmark and defined consequences. Funds know how they will be assessed, and they understand what happens when they fail. This makes the regime enforceable and enhances the effectiveness of the regulator.

12. Productivity Commission (2018); APRA (2019); and Treasury (2020).
13. Treasury (2024).
14. Ibid.

While not canvassed in the consultation paper, it bears repeating that introducing subjectivity into the test – such as allowing APRA greater discretion determining failures – would compromise its integrity and risk the gains made to date.

Funds can always find an excuse for their under-performance or high fees, and regulatory risk-aversion suggests this could lead to the regime being toothless. If subjectivity were introduced into the test, any adverse judgments by the regulator would be exposed to perpetual legal challenges.

2.3 There is no clear winner among the proposed alternatives

Adjusting for the level of risk in an investment strategy is the core challenge of performance testing. The existing methodology does this by tailoring benchmarks to products' strategic asset allocation. The consultation paper for this review canvassed other methods that used alternative approaches:

- Methods that use the volatility of returns as a proxy for risk. These include the Sharpe ratio and the 'simple reference portfolio' test.
- A method that uses the share of 'growth' assets as a proxy for risk – the 'peer-comparison' test.

None of these are obviously superior to the current framework. Using either the volatility of returns or the share of growth assets as proxies for risk introduces new issues.

The volatility of returns will favour funds with high proportions of unlisted assets, and create incentives regarding the frequency and method of their valuation. Further, the meaningfulness of period-to-period volatility for a young member with a decades-long investment horizon is questionable.

There is no consistent industry view on what constitutes a 'growth' asset. An industry-led consultation process in 2020 failed to achieve consensus.[15] It will hard for the testing regime to be enduring if the parties being tested fundamentally disagree on the definition of a key input.

Last, a multi-metric test, while intuitively appealing due to its ability to capture a broader set of information, also introduces problems. There will be disparate views on the appropriate set of metrics and their relative weight. And more metrics would increase the complexity of the test and dilutes its transparency.

In the absence of a clearly superior alternative, the status quo should be retained.

15. Bell (2020).

3 Carve-outs are bad policy

3.1 The expansion into the choice sector was the right call

In 2023, the test was expanded to 'trustee-directed products' (TDPs) – a subset of accumulation choice products that includes most multi-sector accumulation investment options.[16]

This was the right call. The Productivity Commission concluded that there was unhealthy competition in the choice segment, as shown by an excessive number of products ('product proliferation'), poor performance, and high fees. The Commission found that about 36 per cent of choice options analysed were under-performing, and that choice product fees were markedly higher than those for MySuper products.[17]

More recent analysis by APRA concluded that more than 60 per cent of choice investment options had under-performed benchmarks, and 25 per cent of options delivered very poor returns. APRA also concluded that fees and costs in choice products were considerably higher than MySuper products, without obvious benefit in financial outcomes for members.[18]

Some industry players argued that there was little justification for expanding the test to choice products given their members have engaged and made active decisions.[19] However, the outcomes outlined above indicate serious market failure because of the difficulties members have in assessing product quality. It is very easy for members to switch from a MySuper product to a choice one, regardless of their financial literacy.

16. The 'trustee-directed product' definition excludes single-sector options (e.g. Australian shares only), those managed by an unconnected entity, products that give members direct control over investments, and retirement products.
17. Productivity Commission (2018, pp. 22, 148, 181).
18. APRA (2021b, pp. 11–13).
19. JANA (2020, p. 2).

Members should not face a regulatory protection 'cliff' after an activity that takes only a few minutes and exposes them to the prospect of even higher fees and worse performance, potentially costing them many thousands of dollars in foregone super savings by the time they retire.

Investment options available via platforms and similar channels should remain subject to the test

The investment options available via platforms and other more sophisticated channels should continue to be tested. These are mostly offered by retail funds. The under-performing choice products identified by the Productivity Commission were almost exclusively offered by retail funds.[20]

Therefore, a platform carve-out risks leaving some of the worse-performing choice products outside the regime. It would also create a strong incentive for funds to move simpler choice products onto platforms to avoid the test.

3.2 Any leniency for environmental, social, and governance investments should be informed by compelling evidence

Many commentators have claimed that the test is hampering investments in specific environmental, social, and governance (ESG) investments of 'national significance', such as renewable energy projects.[21]

Any leniency or accommodation made for specific investments should be informed by compelling evidence. In particular, that such investments:

20. Productivity Commission (2018, p. 148).
21. Dibley (2024).

- Are being avoided specifically due to the performance test.
- Are otherwise facing difficulties finding investors and face a higher-than-otherwise cost-of-capital.
- Materially matter for the nation (e.g. contribute to the transition to net zero).
- Would produce good returns for members.

In the absence of each of these contentions being substantiated, a carve-out simply risks weakening the test for little or no gain.

General ESG products should be accommodated where it doesn't compromise the integrity of the test

An increasing number of super funds are offering products that target environmental, social, and governance (ESG) considerations by screening out 'undesirable' investments.

Some commentators have raised concerns that the performance test, as currently designed, punishes this approach by increasing tracking error against the test benchmarks.[22]

However, any changes to the performance test to accommodate ESG investing must not undermine the integrity of the test, and should only proceed subject to two conditions being met.

First, the regulations would need a robust, game-proof definition of ESG investment. This is no easy task. ESG language is currently used liberally, and recent ASIC investigations pointed to widespread 'greenwashing'.[23]

Second, investment benchmarks that reflect that definition would need to be available to assess the performance of ESG funds.

22. For example, see: Taylor (2022).
23. Read (2022).

In the absence of these two requirements being met, any special treatment for ESG options risks creating a regulatory back door for super funds to re-badge their products as targeting ESG objectives in order to avoid the performance test.

3.3 A review should assess further expansion of the test

Any decision to expand the performance test beyond trustee-directed products – to single-sector, externally-managed, member-directed, or retirement products – should be the subject of a review, as committed to by the previous federal government.[24]

In particular, any expansion to retirement products would need careful consideration. Most current retirement offerings are essentially simple multi-sector portfolios that would fit the existing test framework. But the retirement income covenant has introduced broader objectives for trustees to consider for the retirement phase, above fees and returns. Subjecting retirement products to the performance test could create a conflict with these broader objectives.

Nonetheless, a strong purpose-built regulatory framework for retirement products is still needed. At present, retirement products are regulated more lightly than accumulation, despite being more complicated and the stakes for the member being higher.[25] This risks the proliferation of products of varying quality as a growing number of Australians retire – similar to the experience of accumulation-phase products over the past 15 years. This will be the subject of a future Grattan Institute report.

24. Australian Parliament (2021, p. 3133).
25. For instance, many pooled retirement products that manage longevity and other risks are 'one shot' games – once members commit to the product they are unable to leave.

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