

Treasury Laws Amendment (Your Future, Your Super) Bill 2021 Submission

18 March 2020

David Bell

David Bell is willing to appear before the Senate Economics Committee to present on any aspect of this submission or any research undertaken by The Conexus Institute relating to the Your Future, Your Super reforms.

About The Conexus Institute

The Conexus Institute is an independent, not-for-profit research institution focused on improving retirement outcomes for Australian consumers. The Institute is supported by the insights of a high-quality advisory board, whereby each member's involvement is on a pro-bono basis. The Institute adopts a research-for-impact model and frequently collaborates with researchers from academia, associations, and industry. Research is generally made open source to create transparency and accountability. All research on the Your Future, Your Super reforms has been made open source. The Conexus Institute exists with no commercial relationships. Further information [here](#).

About David Bell

Dr David Bell is Executive Director of The Conexus Institute. Bell's career has been dedicated to the investment and retirement sector. He has worked with both commercial and profit-for-member firms, and ran his own consulting firm. Bell worked with APRA in the development of the APRA Heatmap. Academically, Bell taught for 12 years at Macquarie University and last year completed his PhD at UNSW which focused on retirement investment problems. Full bio [here](#).

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1. Summary

All our work is based on the documents at hand (i.e. regulations are not available).

Overall, we identify positive elements in the package of reforms embedded in Treasury Laws Amendment (Your Future, Your Super) Bill 2021 (hereon 'YFYS'). In particular, the intent to remove unintended multiple accounts, create greater accountability for investment performance, and improve transparency are noteworthy.

However, much of this submission is allocated to raising significant concerns associated with the design of the reforms themselves.

The proposed stapling model (single default account) appears to remove competition by pre-ordaining winners while likely increasing the incidence of inappropriate insurance cover. Here there are a range of alternative solutions which warrant consideration.

The YFYS performance test, while we acknowledge the positive intent, is deeply flawed. Our research (all open source, available [here](#)) demonstrates that the performance test will prove statistically ineffective over time at differentiating between good and poor funds. We calculate that the performance test will constrain funds to such a degree that it will incur opportunity costs to consumers (\$3.3b per annum) which far exceed the projected aggregate benefits of all the YFYS reforms (\$17.9b in total over 10 years). We identify an additional range of undesirable outcomes relating to funds, consumers, and industry structure. Assuming that policymakers are insistent on a bright-lines test, we propose a relatively simple solution which addresses many of these issues.

Other submissions are better placed to reflect on aspects of the Best Financial Interests Duty such as over-reach. Our specific concern relates to the interaction of policy design. Due to the stapling model and its impact on competition, we are concerned about a system increase in marketing spend (which we believe will have a net negative impact on consumers). We are not confident that the Best Financial Interest Duty will protect against this scenario.

Undoubtedly superannuation has become a very difficult area for policy design. It is difficult to access independent feedback. That is the reason why The Conexus Institute was created. We hope that our feedback and suggestions add value to policy design and consumer outcomes.

2. Acknowledgement

A working group of investment researchers collaborated to explore the YFYS performance test. The work in this submission which relates to the YFYS performance test has been largely taken from work released by The Conexus Institute and reviewed by the working group (all research is available [here](#)). However, the author takes full ownership and responsibility for all material presented in this submission.

The author would like to recognise members of the working group: Nick Callil and Tim Unger from Willis Towers Watson, Andrew Boal from Rice Warner, Emily Barlow and Clayton Sills from Mercer, Matthew Griffith from JANA, and David Carruthers and Kim Bowater from Frontier.

3. Background Observations

We make the following background observations which inform a lot of our analysis:

1. The Productivity Commission (PC) observed a lack of competition in the market (default superannuation). Creating competition is a difficult problem to solve when it relies on disengaged consumers to make an active choice.
2. The PC viewed that the benefits of industry size are not being fully realised and not reaching all consumers.
3. It's important to ensure that default arrangements are the 'exemplar' (the term used by the PC).
4. The PC's recommendations were designed as an integrated package. Government has cherry-picked from these recommendations. There is a risk that this distorts the achievement of intended outcomes.
5. Performance between funds is extremely difficult to compare. Ongoing academic research into performance demonstrates that no one single metric is capable of perfectly assessing performance outcomes.
6. There is a large dispersion in performance outcomes amongst super funds. This exists for many reasons, some of which relate to the performance measure itself.
7. Industry will react to the rules and adjust to maximise their outcomes.

4. Analysis of the YFYS Reforms

There are many ramifications of the YFYS reform package. We only discuss areas which we have researched in detail.

4.1. YFYS – Single Default Account (Your Super Follows You)

The workings of the Single Default Account model (detailed in Diagram 1) are different to those recommended by the Productivity Commission (Diagram 2).

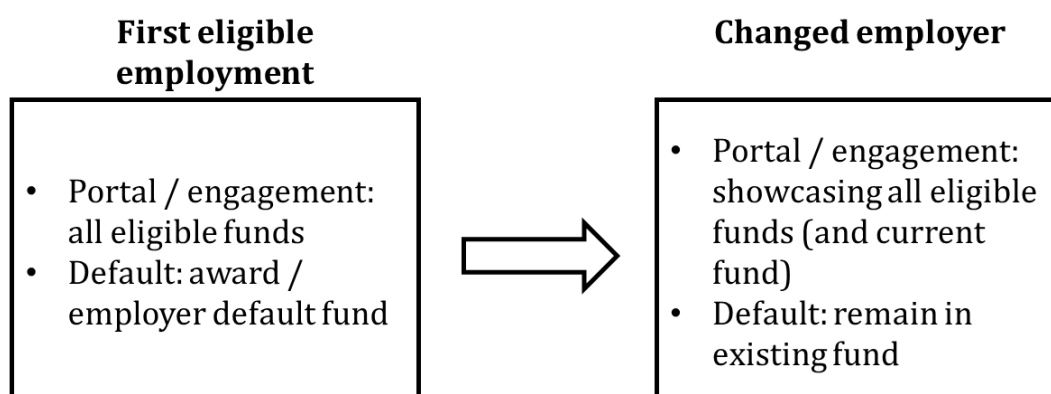


Diagram 1: Single Default Account workings (interpreted into diagram).

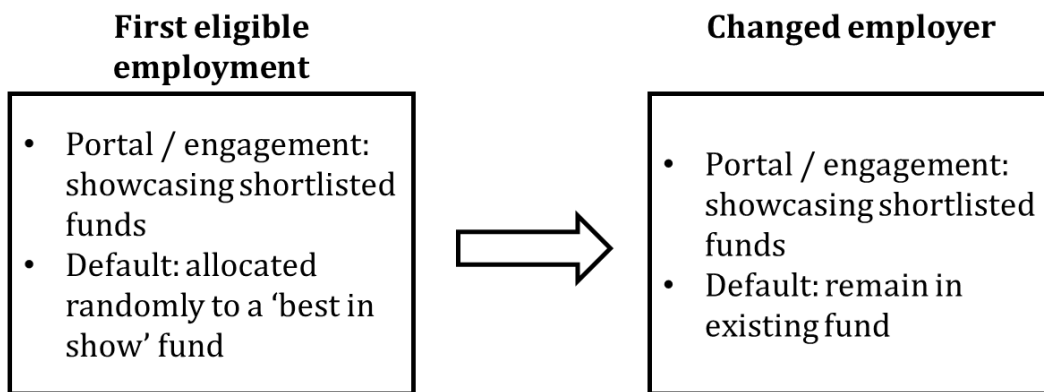


Diagram 2: Single Default Account workings (interpreted into diagram).

The significant difference between the two models is the default approach at first employment. The Productivity Commission recommendation was for the default arrangement to be based on a 'best in show' list of funds, whereas the Your Future, Your Super approach is based on existing award / employer default fund arrangements.

We make three observations that we believe are important for the Committee to reflect on:

1. Benefits to members: The Productivity Commission estimates that a 'best in show' model provides as much if not more benefit to consumers as the performance test (in conjunction with the 'Elevated Outcomes Test'). The PC identify that a 'best in show' model is essential to creating a competitive environment which rewards efficiency and successful innovation. Figure 1 summarises this using analysis produced by the PC.

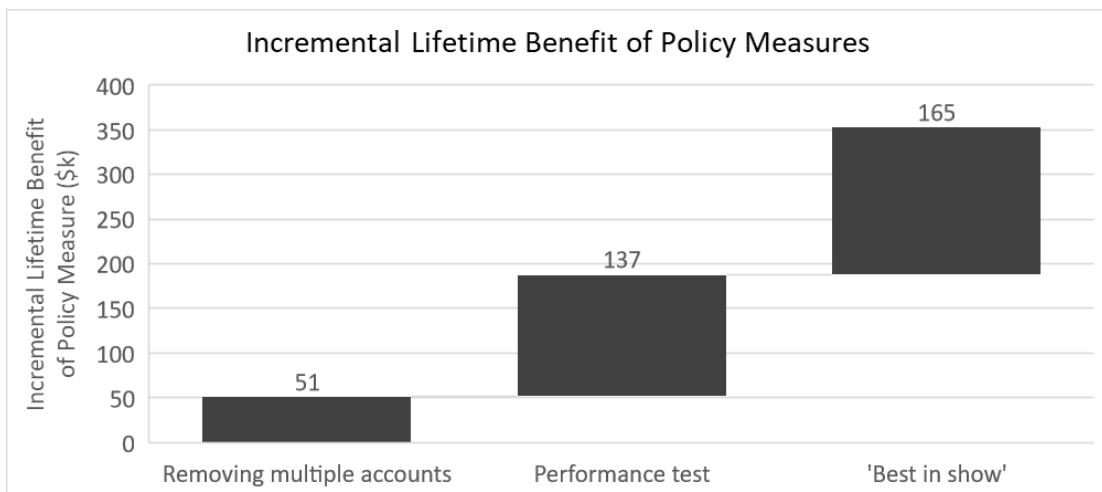


Figure 1: Incremental lifetime benefit of different candidate policy measures associated with single superannuation account. Numbers are sourced from Productivity Commission Inquiry "Report Superannuation: Assessing Efficiency and Competitiveness" (Meme 12.2 and Figure 12.1).

2. Competition: we believe it is important that healthy competition exists in the provision of quality superannuation products and services for members. When we consider the YFYS proposed model we cannot see how competition is enhanced; indeed, we can only identify disincentives.

As agents it would be rational for first employer funds to prioritise member retention strategies and to not fail the YFYS performance test. The opportunities for other (non-first employer) funds to compete is largely through engagement with consumers. Our concern is that marketing-based competition increases system cost. We also have reservations around whether consumers will recognise the benefits of innovations which can be quite complex.

3. Insurance: insurance arrangements are important. Tailored arrangements, appropriate to employment features (income and occupational risk) are valuable, but it is difficult to quantify the value. In the absence of standardisation and clear regulatory guidance, the design of insurance arrangements remains a trustee decision which, in some cases, involves a degree of paternalism. Our work with insurance specialists suggests that, especially over the short-to-medium term, the YFYS model will lead to an increased incidence of the disengaged having inappropriate insurance (albeit those same disengaged individuals could have multiple insurance arrangements which is worse), while increasing overall insurance costs (due to non-homogenous pools proving more difficult to price). Over time if industry develops more standardised approaches to insurance (e.g. data collection) then costs and the degree of cross-subsidisation may improve.
4. Workplace engagement: for some industries, funds work closely with employers (and sometimes unions) to provide financial literacy, engagement, and wellbeing programs. These can be a valuable source of education and engagement, but difficult to quantify the numbers or the benefit. This model will likely break down over time under both the YFYS and PC proposed models.

The stapling model detailed in the YFYS legislation removes the multiple account issue and prevents first job employees being placed in funds which have failed the performance test. But the model has residual issues regarding benefits to members, competition, insurance, and engagement. These residual issues, partly identified by the PC itself, lead us to consider a third stapling model, outlined in Diagram 3. A single account persists through life (unless an individual makes an active decision to have multiple accounts) but the default provider switches to the new employer’s award / default arrangements.

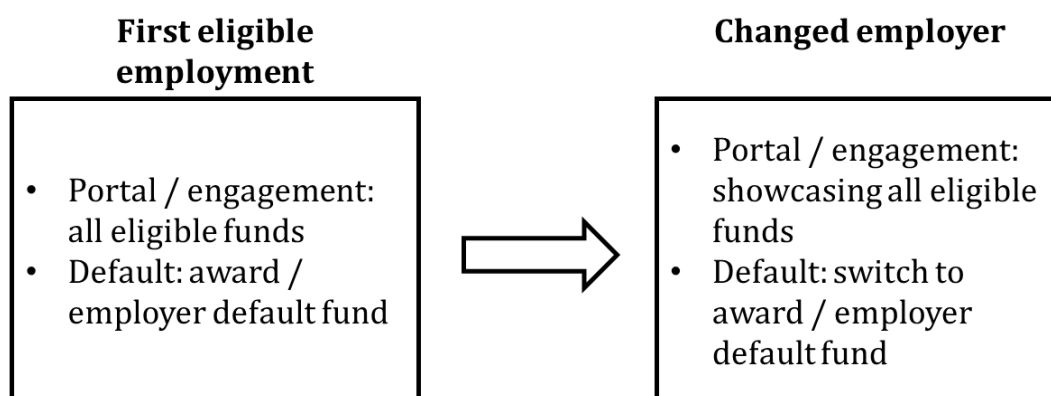


Diagram 3: Alternative single account model: single account which moves to new employer’s default / award fund.

The comparative features of the three models are summarised in Table 1. We do not consider engagement in Table 1 but note that existing employer / fund engagement models would be preserved under the alternative model detailed in Diagram 3.

	Quality of initial fund placement	Impact on insurance	Competition amongst super funds
YFYS (Diagram 1)	<ul style="list-style-type: none"> • Baseline of passing YFYS performance test. 	<ul style="list-style-type: none"> • Reduced occupational relevance for the disengaged who change occupations. • Potential for higher costs due to increased non-homogeneity in pools. 	<ul style="list-style-type: none"> • All competition is engagement-based where financial literacy standards are low. Career events will be an obvious opportunity for engagement. • Engagement-based competition is expected to increase system costs. • First employer funds incentivised to prioritise retention and not failing the performance test.
PC (Diagram 2)	<ul style="list-style-type: none"> • ‘Best in show’ model intended to ensure high quality initial allocation. 	<ul style="list-style-type: none"> • Insurance would be assessed in the ‘best in show’ process, presumably accounting for multi-occupation. • This could institutionalise move to multi-occupation pricing by insurers. 	<ul style="list-style-type: none"> • Engagement-based competition, particularly at career events. • Institutional competition for ‘best in show’ appointment motivates competition amongst funds.
Alternative model (Diagram 3)	<ul style="list-style-type: none"> • Baseline of passing YFYS performance test. 	<ul style="list-style-type: none"> • Insurance continues to run along occupational lines. 	<ul style="list-style-type: none"> • All competition is engagement-based, particularly for retention at career events.

Table 1: Single default account workings – different models compared.

When we consider the summary provided in Table 1, we consider both the PC and alternative models to have greater net benefits than the YFYS model.

The PC model introduces institutionalised competition which, if well-implemented, would be expected to continue to drive benefits for members. Here the PC’s statement is impactful: *“In a world of compulsion the onus is on government to ensure that default superannuation is the system exemplar”*. It is hard to see how this will be achieved in the YFYS model.

Both the YFYS and the alternative model introduced in Diagram 3 leave employers to put in place and maintain employee award / default fund arrangements. On this the PC concludes that *“even with the best of intentions, many employers are not well equipped to choose default funds, and most do not want to do so”*. However, the alternative model compared to the YFYS model at least ensures that insurance arrangements have greater relevance to the individual’s present occupation.

Other alternatives include reforming the award super process to encourage greater competition (which would improve the effectiveness of Model 1 and Model 3) or introducing a national default fund (which would also apply to Models 1 & 3). A national default would remove dispersion of outcomes between similar individuals placed into different super funds.

While we don’t make a recommendation on the best single account model, we believe there are various alternative models which provide greater net benefits to consumers than the proposed YFYS model.

4.2. YFYS – Addressing underperformance in superannuation (Performance Test)

4.2.1. Performance test explained

The YFYS performance test, as proposed, is a backwards-looking assessment of investment performance. Illustrated in Diagram 4, we consider the test a crude measure of implementation alpha (‘crude’ because of the limited number of public market benchmarks used and notably non-representation of benchmarks for unlisted assets). It ignores other important sources of return and it ignores the risk taken to achieve those returns.

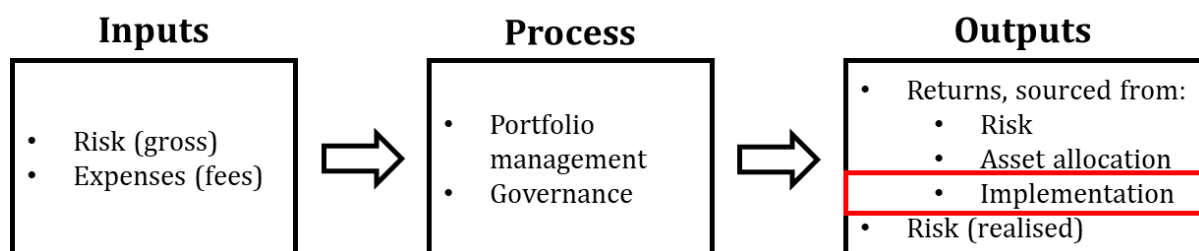


Diagram 4: Process representation of investment management. The red box reflects the focus of the YFYS performance test.

It is important to consumer outcomes that any performance test is a broader measure of returns which accounts for risk. Consumer outcomes are driven by total returns. Two simple examples (keeping in mind the -50bp per annum performance test threshold) of investment decisions which are not captured in this measure (they link in with Diagram 4):

- Risk: allocating 10% more to growth assets over the last 8 years would have added 57bp per annum.

- Asset allocation: allocating 10% more to global shares rather than Australian shares would have added 43bp per annum.

There will be cases where funds (presently and in the future) which have failed (passed) the YFYS performance test will deliver higher (lower) returns than other funds which passed (failed) the test.

The issue of risk is important. All else equal, members in funds with lower risk experience a narrower range of possible retirement outcomes, providing them with greater confidence. This has financial planning and wellbeing benefits. Funds actively manage the risk in their portfolios by putting together different assets which aren't expected to perform well at the same time. This is generally known as diversification. The test is agnostic to the management of risk. Indeed, in many cases the test penalises diversification and risk management strategies.

The test is 'bright lines' in nature, interpreted to be an attempt to remove additional qualitative assessment.

4.2.2. Statistical effectiveness

We have researched the statistical effectiveness of the YFYS performance test, where effectiveness refers to the ability to identify poor performers and not mistakenly identifying good performers as poor. This was a reasonably complex exercise (all papers and models have been reviewed and are available [here](#)). Reflected in Diagram 5, we identified three issues which impact the effectiveness of YFYS performance test results.

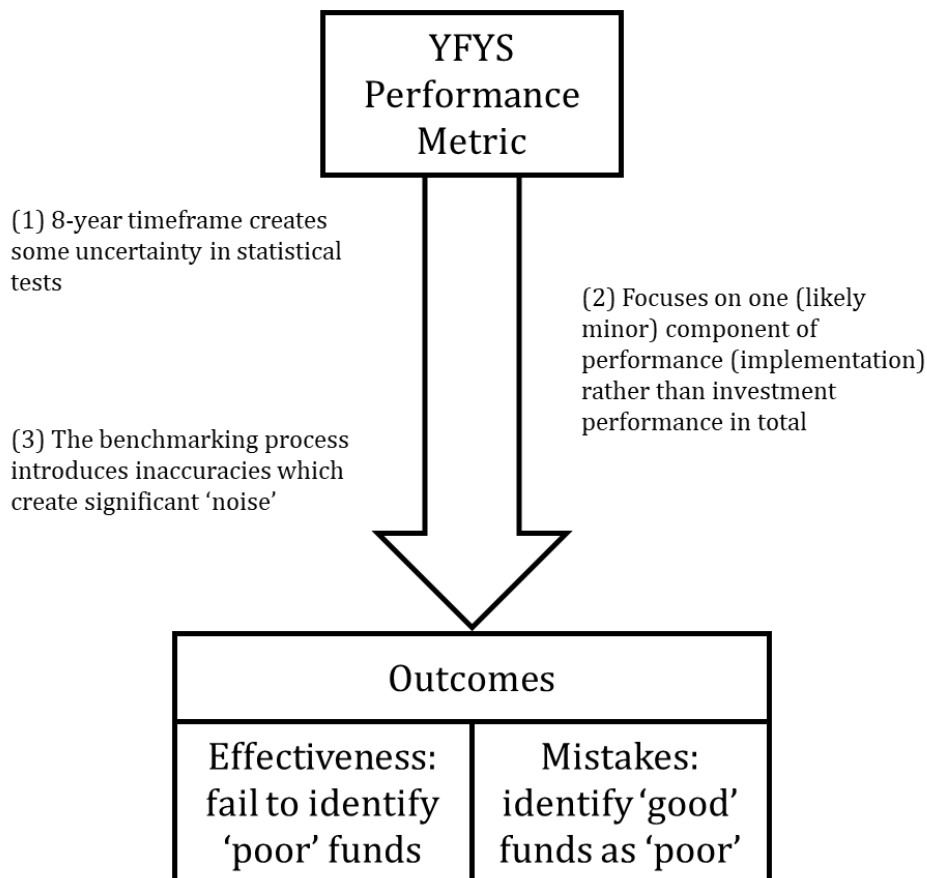


Diagram 5: Detailing concerns around the effectiveness of the YFYS performance metric.

In Diagram 5 'benchmark noise' is created by benchmarking an asset class with an index which does not accurately track the short-term performance of that asset class. There are many asset classes impacted, most notably private equity, unlisted property, unlisted infrastructure, all forms of credit, inflation-linked bonds, and the entire universe of alternative assets. The single performance component issue relates back to Diagram 4.

We developed a statistical test to assess the overall effectiveness of the YFYS performance metric. The results are summarised in Table 2. Overall, across a range of realistic scenarios the effectiveness of the YFYS performance test was assessed to be very weak (in the context that a coin-toss would result in 50% outcome for effectiveness and mistakes). Note that the performance test is likely to be effective in the most egregious cases (i.e. severe underperformance).

Test	Likelihood
Effectiveness: likelihood of failing to identify a 'poor' fund as 'poor'	42% - 65%
Mistakes: likelihood of identifying a 'good' fund as 'poor'	35%

Table 2: Assessed statistical effectiveness of the YFYS performance metric. For more details see the Detailed Paper.

When we analysed the drivers of these weak results, issues 2 (the test only focuses on one component of performance) and 3 (benchmark process shortcomings) were the primary contributors.

4.2.3. Impact on portfolio management

We deeply researched the impact of the YFYS performance test on the investment strategies of super funds. This involved recognising that:

1. The YFYS performance test will be the binding piece of regulation (because of its bright lines nature and the strong consequences of failure) amongst various regulatory instruments (e.g. APRA Heatmap, Outcomes Assessment Test etc).
2. Trustees will be heavily motivated to design an investment strategy which has a high likelihood of passing the performance test.
3. Trustees will not want to have to frequently alter their investment strategy to maintain the likelihood of passing the performance test. This will incur transaction costs and may not be practical (e.g. illiquid assets).

The modelling behind this research is quite detailed (full paper [here](#)). What we found was that many funds will find that they are significantly constrained and will likely have to make large changes to their investment strategy to account for the performance test. The alternative, illustrated in Diagram 6, is that they continue with their present investment strategy but face an undesirably high risk of failing the performance test or having to change the investment strategy due to intermediate performance results.

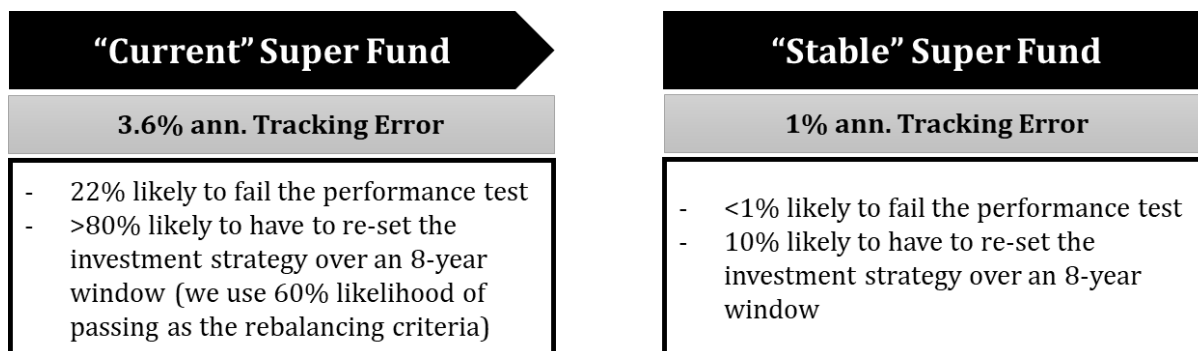


Diagram 6: Detailing concerns around the effectiveness of the YFYS performance metric. Here tracking error is the volatility of performance relative to the YFYS benchmarks.

Diagram 7 illustrates the difference in investment strategies which could populate the “Current” and “Stable” strategies detailed in Diagram 6.

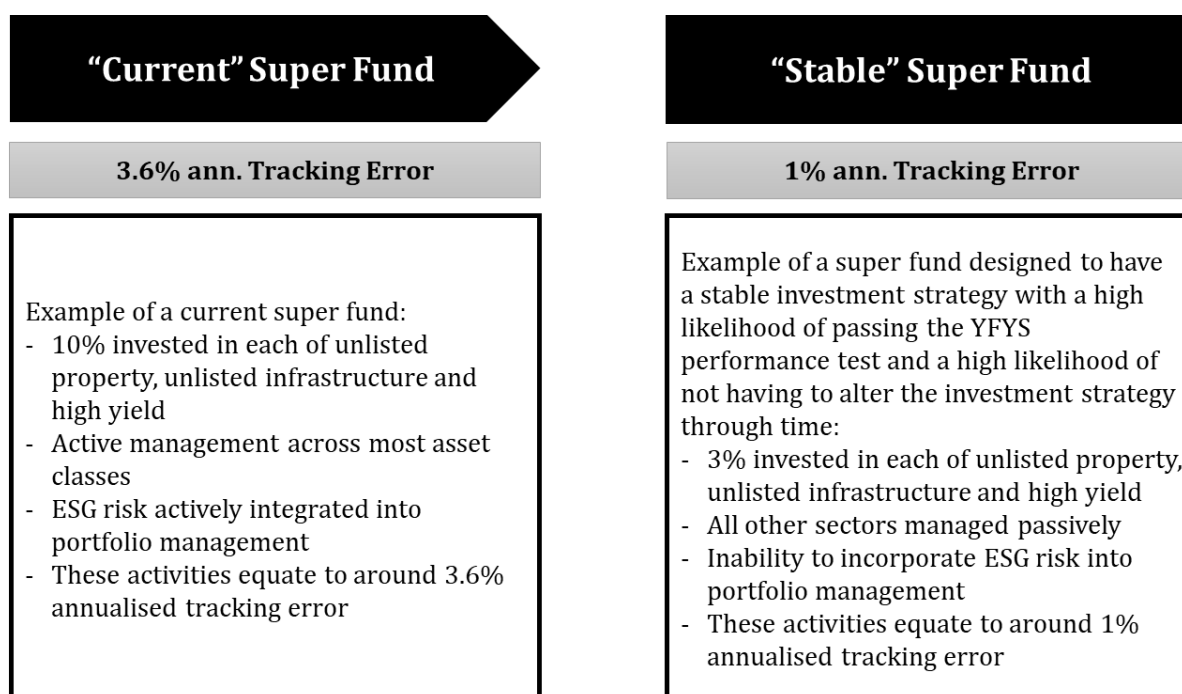


Diagram 7: Sample investment strategy characteristics of a “Current” and “Stable” fund.

Our research illustrates the difficult situation faced by Trustees of super funds. In our view the YFYS performance test does not align well with managing portfolios in the best interests of members. We think many Trustees will discover that portfolios designed to pass the performance test may have lower expected returns, be less effectively diversified, and bear more risks than portfolios constructed in the absence of the performance test.

4.2.4. Impact on consumer outcomes

We researched the opportunity cost to consumers of the Your Future, Your Super (YFYS) performance test. We estimate that, should funds prioritise passing the performance test, consumers will incur an opportunity cost of \$3.3b per annum. This far exceeds the benefit of the YFYS performance test (forecast in the Budget to be \$10.7b over 10 years). Indeed, the

opportunity cost is larger than the forecast benefits of the entire YFYS reform package (\$17.9b over 10 years).

What generates such a significant opportunity cost? The YFYS performance test will cost consumers because it will constrain super funds from constructing portfolios which are in members’ best interests. This generates opportunity cost in terms of less effective risk management and less investment in opportunities expected to generate outperformance over time.

We only assessed the return opportunity cost and do not consider the risk impacts. In this respect it could be challenged that our analysis understates the full impact of the performance test on consumers.

The assumptions used in this type of analysis are always open to challenge. We consider our assumptions to be conservative. The full research including a self-assessment of assumptions is [here](#).

4.2.5. Other undesirable outcomes / unintended consequences

In addition to the issues of statistical effectiveness, constraining impact on portfolio management and associated opportunity cost to consumers, we identify a range of additional undesirable outcomes. These could be considered unintended consequences of policy design if Treasury (or the PC) hasn’t undertaken the appropriate research during policy design and assessment. Our concerns are grouped into three categories and are detailed in Table 3. For further detail on any of these points [here](#) (sections (3.1) – (3.3)).

	Issues identified
Concern 1: How funds will invest	<ul style="list-style-type: none"> • Dangerous incentive for funds which are well behind on the performance test to ‘swing for home runs’ and take high tracking error relative to benchmark. • Actively managing (in the worst case, gaming) the performance test by taking advantage of benchmark shortcomings. • Poor alignment with portfolio management approaches such as total portfolio approach (TPA). • Deterrent to strategies which reduce risk and provide diversification. • Features of the YFYS performance test do not match up well with future portfolio management challenges.

<p>Concern 2: Direct impact on consumers</p>	<ul style="list-style-type: none"> • Given the low statistical effectiveness of the performance test super funds may ‘contest’ the result with their members, creating confusion. • The YFYS performance test result may create confusion for consumers when placed alongside total performance on the YFYS Comparison Tool. • Potential for a large cohort of funds to fail the YFYS test concurrently (due to benchmarking noise), reducing system confidence. • Does not remove consumers from investment products with assessed high administration fees. We are not confident that consumers can piece together multiple pieces of information and make a balanced decision. • Penalises the heavily disengaged who may remain in a fund which becomes more impaired.
<p>Concern 3: Impact on industry structure</p>	<ul style="list-style-type: none"> • A deterrent to consolidation as funds will be hesitant to merge with other funds which may dilute their portfolio quality, impair their inflow profile, or distract management focus. • Potential for ‘zombie’ funds which are impaired partly due to the performance test, making them an unattractive merger partner.

Table 3: Summary of undesirable outcomes likely to result from the YFYS performance test. For more details see the Detailed Paper.

4.2.6. Principles for an improved performance test

When the Working Group considered how to improve the YFYS performance test (to be an effective performance test with limited undesirable outcomes), we began by developing a set of agreed design principles. We share these below:

1. Developing an effective performance test is a great opportunity to improve superannuation outcomes for consumers.
2. It is important to minimise any undesirable outcomes created by introducing a performance test.
3. The ramifications of failing any performance test need to be proportional to its reliability.
4. Qualitative assessment by an entity such as APRA would acknowledge changes made through time by super funds to address past performance issues.
5. A well-designed collection of multiple metrics is likely to be more reliable and effective than a single metric.

6. If the intention is for a consumer outcome test, then it makes sense to include administration fees.

4.2.7. Solutions for a better performance test

Our analysis identifies a range of significant shortcomings in the performance test, which appear to more than offset the identified benefits of the YFYS reform package.

The range of solutions is only limited by the constraints one assumes. This requires us to estimate the non-negotiables, and we assume just the one (note that this does not mean we endorse it – as per Principle 4 above):

- Policymakers desire a bright lines test with no ability for qualitative assessment to complement the quantitative test.

We consider and self-assess three areas of possible improvement.

1. Inclusion of administration fees: this may appear a simple issue, but it is rather nuanced. The inclusion of administration fees makes the performance test a more appropriate assessment of total outcome to consumers. We also note that many funds, particularly retail funds, have significant flexibility in how they allocate expenses between investment and administration.

However, administrative fees can be difficult to incorporate into metrics because they are commonly multi-component (a mixture of fixed and account balance fees) and require account balance assumptions (through life). Further, incorporating administration fees into a quantitative performance test inherently assumes that all funds provide an identical range and quality of services, which isn't the case.

On the balance of issues we believe that, especially in a default fund setting, it is appropriate to incorporate administration fees into the performance test. Trying to frame this purely as an investment test is purely a conceptual exercise; in reality it will perform the role of a consumer test.

2. Incorporating additional asset class benchmarks: there is a school of thought that including indices for unlisted property and unlisted infrastructure will remove most of the issues with the proposed YFYS performance test. Unfortunately, this is not the case.

There are many asset classes which are not benchmarked accurately. Our research identifies that it would take at least 50 asset class benchmarks to accurately measure implementation performance (even then it won't be perfect). For instance, just in the fixed income and credit space we find it would take at least 12 indices. At present APRA doesn't have the systems capability to administer such a detailed performance test (though they are looking to improve their ability in this area via the Superannuation Data Transformation project).

Second, this will only address issue 3 in Figure 5. Significant shortcomings will persist due to issue 2 in Figure 5.

Overall, adding further indices will improve the effectiveness of the metric but the performance metric will remain statistically ineffective. Many undesirable outcomes will persist.

3. Introduce a second, complementary metric: our view is that the addition of a well-considered second metric, which is different to the existing YFYS performance test, could improve the effectiveness of the overall performance test and remove many of the undesirable outcomes.

Other submissions will likely recommend a range of metrics. A range of metrics can become complex and it is difficult to weight each metric. Our proposed approach is simple: two metrics, and if you fail them both you fail the YFYS performance test.

From our research we modify a metric based off the research of Nobel laureate William Sharpe (it is fully explained in Appendix 1). It is based purely off the realised performance of funds (so none of the benchmarking issues), and accounts for risk (i.e. the realised volatility of returns).

In Table 4 we consider our primary critiques of the proposed YFYS performance test and consider how these are addressed by our proposed second metric.

Issues identified with YFYS performance test	How proposed second metric addresses the issue
1. The test fails to acknowledge all elements of performance (as detailed in Diagram 1).	The proposed metric accounts for all sources of return.
2. The test has a large range of benchmarking issues.	This test involves no benchmarking of performance.
3. The test fails to acknowledge diversification benefits.	The test is based on realised volatility which accounts for realised diversification benefits.

Table 4: Analysis of how the proposed second performance metric addresses the identified weaknesses of the YFYS performance metric.

Every performance metric has weaknesses. The proposed second metric is not perfect either. It has some weaknesses which are partly addressed by the YFYS performance metric. The most notable issue is that the realised volatility of unlisted assets may be understated. Given these same assets are effectively ‘penalised’ by the YFYS performance test benchmarking process, so again we see the two tests complementing each other.

Our initial consideration is that the addition of a second test may result in a 20% reduction in funds initially identified as poor performers (e.g. 25 funds down to 20). It will improve the effectiveness of the test. We believe the second test will significantly reduce undesirable outcomes as it aligns strongly with investing for member best outcomes.

4.3. YFYS – Best Financial Interests Duty

Other submissions will undoubtedly highlight the risk of government intervention in investment and operational spending. We share those concerns and take the view that any outcomes of this

nature risk inhibiting the achievement of member best outcomes. We believe there are other regulatory solutions to these issues.

We raise a single concern which relates to marketing, specifically the risk of a significant increase in industry marketing spend.

4.3.1. Risk of a marketing “free-for-all”

We have strong concerns that industry will significantly increase marketing spend to the detriment of consumers. This is partly attributable to the design of the stapling model (pre-ordained winners, with consumer engagement the only point of competition). We are concerned that the Best Financial Interests Duty will not prevent this adverse outcome.

We explain how this scenario could eventuate:

1. The intention of account stapling is to reduce flows into non-first employer funds, particularly as a second account.
2. In response to loss of fund inflow, adversely affected super funds are likely to market more to consumers.
3. Since marketing is a zero-sum activity (a member rolls out of one super fund into another), even first employer funds may increase marketing to defend their membership.

Will Best Financial Interest Duty restrict the proliferation of marketing? Unlikely – Example 3.3 in the Explanatory Materials details an example where marketing can be justified because it resulted in new members and operational cost efficiencies. Only a modest extension to this example is required to justify marketing by all funds, based on a more nuanced interpretation of marketing success, namely the recognition that marketing prevents membership departures to other funds. We provide a mock example below.

Additional Example

Blue Super Funded decided to fund a television marketing campaign to promote their fund, spending \$5 million of members’ money. Due to the marketing activities of other funds Blue Superannuation Fund believes they would lose 5,000 members if they undertook no marketing. Blue Superannuation Fund believes that marketing spend will lead to the fund retaining its membership. This will allow the trustee to maintain operational costs and preserve the investment strategy including the allocation to illiquid assets.

Our concern is that a perpetuating cycle of system marketing spend may evolve (like a Tournament Theory problem) which has a net negative impact on consumers. We are concerned that the Best Financial Interests Duty will not prevent this adverse outcome. A different policy measure may be required.

4.4. YFYS – Information Portal

We are concerned around how consumers will make an informed decision surrounding a fund identified as underperforming. Table 5 sets out a simple example of a fund (Fund A) which fails the YFYS performance test but delivers higher returns than one (Fund B) which passed the performance test.

Performance component	Fund A	Fund B
Implementation (YFYS Performance Test)	-0.5% pa	0% pa
SAA	+0.5% pa	-0.5% pa
Risk-based performance	7.0% pa	7.0% pa
Total performance	7.0% pa	6.5% pa

Table 5: Simple case study to highlight difficulties of communicating to consumers a failed performance test.

We consider the likelihood of the scenario identified in Table 5 to be almost certain. We note in Table 5 that Fund A and Fund B have a similar level of overall risk exposure and, all else equal, would be expected to generate similar performance. Consider a member of Fund A who receives a letter notifying them that their fund failed the YFYS performance test and referring them to a government-provided comparison website. Our reservations relate to various scenarios faced by consumers such as the following:

- They would see that Fund A outperformed some other funds (e.g. Fund B) which did not fail the test. How would this be explained?
- How will consumers balance issues such as performance, performance test results, administration fees and product risk?
- How will consumers access other important information such as insurance characteristics?
- What guides will there be to assist consumers to balance all the competing criteria and make a good quality decision?

5. Summary

Overall, we identify positive elements in the package of reforms embedded in Treasury Laws Amendment (Your Future, Your Super) Bill 2021. In particular, the intent to remove unintended multiple accounts, create greater accountability for investment performance, and improve transparency are noteworthy.

However, much of this submission is allocated to raising significant concerns associated with the design of the reforms themselves.

The proposed stapling model (single default account) appears to remove competition by pre-ordaining winners while likely increasing the incidence of inappropriate insurance cover. The PC identified the 'best-in-show' model as an important complement to create appropriate competition. Without 'best-in-show' the PC effectively identified that competition will be distorted and this will cost consumers. Here, there are a range of alternative solutions which warrant consideration.

The YFYS performance test, while we acknowledge the positive intent, is deeply flawed. Our research (all open source, available [here](#)) demonstrates that the performance test will prove statistically ineffective over time at differentiating between good and poor funds. We calculate that the performance test will constrain funds to such a degree that it will incur opportunity costs to consumers (\$3.3b per annum) which far exceed the projected aggregate benefits of all the YFYS reforms (\$17.9b in total over 10 years). We identify an additional range of undesirable outcomes relating to funds, consumers, and industry structure. Assuming that policymakers are insistent on a bright-lines test, we propose a relatively simple solution which addresses many of these issues.

Other submissions are better placed to reflect on aspects of the Best Financial Interests Duty such as over-reach. Our specific concern relates to the interaction of policy design. Due to the stapling model and its impact on competition, we are concerned about a system increase in marketing spend (which we believe will have a net negative impact on consumers). We are not confident that the Best Financial Interest Duty will protect against this scenario.

6. Appendix 1 - Proposing an additional single metric

This Appendix outlines a second metric to complement the proposed YFYS performance test.

The dual-metric test would work simply, as follows:

- Fail both metrics → fail the YFYS performance test.
- Don't fail both metrics → pass the YFYS performance test.

Overview of proposed metric

Explained simply, the second metric is calculated as outlined in Diagram A1.

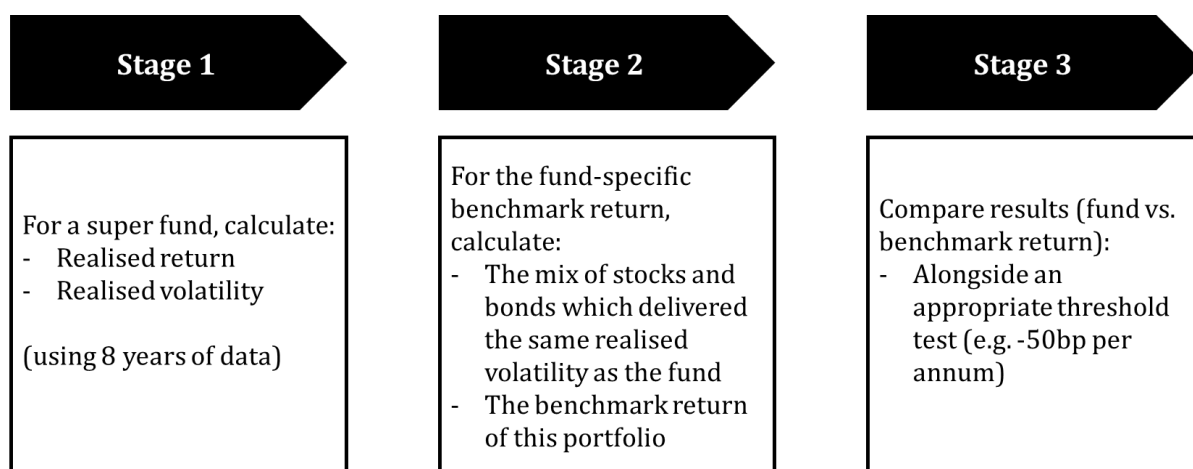


Diagram A1: Simple steps to calculate the proposed second metric.

Full detail is provided [here](#) (refer to Appendix 1). All that is required to calculate the proposed metric is a time series of performance (recommend monthly) and some existing benchmark indices. We note that this metric can easily be adjusted to include administration fees.