FINANCIAL ADVICE ASSOCIATION AUSTRALIA

Director
Members Outcomes and Governance Branch
Retirement Advice and Investment Division
Treasury
Langton Cres
Parkes ACT 2600

Via Email: yfys@treasury.gov.au

2 May 2023

Dear Treasury,

Superannuation Performance Test Regulations 2023

The Financial Advice Association of Australia[1] (FAAA) would like to provide feedback on the draft regulation to amend and expand the Superannuation Performance Test.

The FAAA supports the reporting of meaningful performance test information to members of superannuation funds. However, we have some reservations about the application of this, and some suggestions to improve the operation, as we have set out below.

Summary of Key Recommendations

1. Ensure financial advisers, as a key stakeholder, are involved in consultation and the rollout of these provisions.

[1] The Financial Advice Association of Australia (FAAA) was formed in April 2023, out of a merger of the Financial Planning Association of Australia Limited (FPA) and the Association of Financial Advisers Limited (AFA), two of Australia's largest and longest-standing associations of financial planners and advisers.

The FPA was a professional association formed in 1992 as a merger between The Australian Society of Investment and Financial Advisers and the International Association of Financial Planning. In 1999 the CFP Professional Education Program was launched. As Australia's largest professional association for financial planners, the FPA represented the interests of the public and (leading into the merger) over 10,000 members. Since its formation, the FPA worked towards changing the face of financial planning, from an industry to a profession that earned consumer confidence and trust, and advocated that better financial advice would positively influence the financial wellbeing of all Australians.

The AFA was a professional association for financial advisers that dated back to 1946 (existing in various forms and under various names). The AFA was a national membership entity that operated in each state of Australia and across the full spectrum of advice types. The AFA had a long history of advocating for the best interests of financial advisers and their clients, through working with the government, regulators and other stakeholders. The AFA had a long legacy of operating in the life insurance sector, however substantially broadened its member base over a number of decades. The AFA had a strong focus on promoting the value of advice and recognising award winning advisers over many years. The AFA had strong foundations in believing in advocacy for members and creating events and other opportunities to enable members to grow and share best practice.

2. Amend the performance test model to take account of the way Mastertrust and particularly Wrap products typically operate:

    a. Apportion the fixed product fee based on the average number of holdings per member in the product. For example, if members on average hold 5 investment options, then 20% of the fixed product fee should be apportioned to each investment option for the calculation.

    b. Use the actual fees for each version of a Lifecyle product and the actual investment return for each investment pathway, rather than the worst of each.

    c. Adjust the calculated fees to allow for higher average balances in some products, so that if the average member benefits from a concession (i.e. rebate), then it is taken into account in the calculation. For example, if the average member balance is $250,000, then the fees applicable at that holding level should be used.

3. Provide rollover relief to consumers where a trustee or fund manager closes an investment option and transfers the investors to a different option, such that the rollover does not trigger Capital Gains Tax (CGT) for the consumer.

4. Improve the wording of the proposed notice to acknowledge that there may be good reasons to continue to hold an option identified as underperforming, including tax and insurance considerations, and that consumers should speak with their financial adviser before making any changes.

5. Require providers to ensure a copy of the notice is provided to each member's adviser at or before the time it is sent to the member.

Implications for Financial Advisers and Their Clients

We would like to express our concerns about the consultation process for this important reform. Our concerns relate to the following:

- The FAAA is the leading association for the financial advice profession, however we have not been directly consulted with in respect to this matter, which will have a substantial impact upon financial advisers.

- The Exposure Draft Explanatory Statement makes no reference to the implications of this reform for financial advisers, who are a key stakeholder.

- There has been no impact analysis undertaken, meaning that there has been no consideration of the impact of this reform on financial advisers and their clients.

Financial advisers, whilst not usually involved in the recommendation of MySuper products, are very much involved in the recommendation of Choice products. Where clients receive a notification from their trustee that their fund, or one or more of their investment options, have failed the performance test, then many of them are likely to contact their adviser to either complain or seek advice on how to resolve this problem. The impact of this is now probably only six months away. The financial adviser population are largely unaware of this issue at present, and will have little idea how this assessment is undertaken.

On Wednesday 26 April 2023, APRA issued a media release on the heat map for Choice products that made the following key points:

- One in five Choice investment options with an eight-year history has significantly underperformed the heatmap benchmarks.
- Two-thirds of Choice investment options that are closed to new members had poor or significantly poor performance relative to the heatmap benchmarks.

Trustee Directed Products and Wrap Accounts

Whilst the expansion in 2023 of performance testing is limited to trustee directed products, on the basis of this media release by APRA, it is likely that it will have a very substantial impact upon advised clients. This expansion to trustee directed products will have implications for both Mastertrust products and Wrap products. We envisage potentially significant issues for Wrap products, which are operated very differently to other superannuation products. For example, the impact of CGT is not built into unit prices and is deferred until the product is sold and secondly investment tax is typically not taken from individual products, but instead from a cash account. We believe that these two differences will have a meaningful impact on the way this regime is applied to Wrap products.

Professional Product Selection Processes

In our submission below we address our reservations about the methodology being used with respect to the assessment of poor performance, however it is important to make a few key points:

- Financial advisers typically recommend financial products, including investment options, based upon the selection of products by an AFSL's investment committee that often will be guided by research prepared by leading research houses.
- In terms of a superannuation Mastertrust or Wrap product, the recommended investment options could be in the form of model portfolios, that are broadly used by advisers within that licensee. These model portfolios are carefully monitored and are subject to change

over time as the licensee and research house assess the ongoing performance of each option.

- It is possible that from time to time a product or an investment option will go on “hold”, and no longer be recommended to new clients. This does not mean that it is necessarily classified as a “sell”, as there are invariably a range of consequences in switching funds or selling an investment option, including tax considerations, and in terms of super accounts the potential loss of insurance cover (particularly where the client’s health has deteriorated). As a result, within a portfolio, an investment option that is on “hold” may stay a part of the portfolio of a client for some period of time. A common warning in financial services is that past performance is not a predictor of future performance. This applies in both the context that past good performance is not a predictor of future good performance and past poor performance is not necessarily a predictor of future poor performance.

The research houses, in recommending products (including investment options), will have given thought to the investment performance over a reasonable period of time, however this may not be as long as the ten year period proposed in the performance test. Neither will they have designed these model portfolios with the implications of this performance test in mind. Our concerns are as follows:

- An investment option with good recent performance may still fail the performance test which is assessed over a ten-year period. This should not be an important factor for clients who have not held the product for ten years, and have achieved a good return.

- The notification to the client does not differentiate between a marginal fail and a significant case of underperformance.

- It will not be entirely obvious to the client from the notification, if this is a case of one of seven investment options that have been assessed as failing, or all seven options. That would need to be explained to them by their adviser.

- Simply having one or more investment options that are assessed as failing, does not mean that it would be in the best interests of the client to change funds entirely or to sell the investment options that are impacted.

The Implications of Receiving a Failure Notice

A client who receives one of these failure notifications is likely to form one or more of the following views:

- They have received poor advice, and should either get a new adviser or new advice. They may even consider making a formal complaint.

- They have been placed in a poor product and should change the product.
- That one or more of their investment options is no longer performing and they should speak to their adviser to better understand the issue and what they should do.
- Be less concerned as some investment options have periods of poor performance, however it will likely recover at some point in the near future, and it is unnecessary to change at this stage.

Either way, the adviser will need to proactively contact the client and explain the issue and address any questions that they have. Advisers will need assistance from the product providers and their licensee to have these conversations which at the very least must include a copy of the notice on or before the date the notice is sent to the member. We would like to see formal notice to the adviser being incorporated as part of the process for Choice funds, where there is an adviser attached.

The receipt of a failure notice should not lead to any automatic decision to exit the product or investment option for the following reasons:

- The notice may largely relate to investment performance in the period prior to the client's ownership of that investment option.
- The underperformance may be minor and the alternative options that make up that part of the portfolio may have similar issues with underperformance. This could be the case when particular investment styles (i.e. value investors) have underperformed, and other value managers have also underperformed.
- The benefit to be gained by moving may be substantially less than the cost of moving, which can include the cost of new advice, buy/sell spreads, tax implications (including forced recognition of capital gains) and potentially being out of the market for a period of time.
- The fact that the investment option has not actually underperformed, however underperformance is being suggested as a result of flaws in the assessment methodology.
- In terms of switching super funds completely, the client may have insurance tied to a particular fund that they need to maintain, due to a decline in insurability. It is common practice for advisers to recommend maintaining a small investment balance in a closed product to retain insurance, where there is enough for the earnings from the investment to cover the premiums and administration costs.

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We are very concerned that the mandated failure notices do not adequately explain the issues and the potential complications. There needs to be a very clear message about the importance of access to financial advice, including tax advice, before making important decisions. We would go even further to make the point that the statement **"Switching super products is easy and there are no fees"** is in our view potentially misleading. It is true that there should be no exit fees, however there may be advice fees, buy/sell fees and important tax and insurance implications. The wording of the draft failure notification lacks the necessary level of balance and caution in making important financial decisions.

We make the point that this performance testing has rightly put the spotlight on closed investment options. It is, however, important to note that it is often disadvantageous for clients to exit a closed Wrap account investment option, where they have a substantial capital gain. Being forced to realise the capital gain and pay the CGT certainly may not be in their best interests, particularly where they are close to retirement and could realise this capital gain when they are in pension phase and when no tax would be payable. Rollover relief exists at the fund level through successor fund transfers, however it does not exist at the investment option level. Thus, we believe that to assist with the transfer of clients out of closed investment options that are underperforming, the Government must offer roll-over relief.

Specific Issues with the Methodology

We have the following specific concerns about the methodology that is being used:

- When clients have a Mastertrust or Wrap account, often they will have multiple investment options (we understand that the average is seven for Wrap accounts). The fund will often have a fixed fee at the product level, along with an asset-based fee at the investment option level. As we understand it, the calculation methodology will result in that fixed fee being attributed to each investment option, rather than being divided over the different investment options. This could cause a major distortion, particularly for those funds that have higher fixed fees, but lower asset-based fees. This is an unfair outcome that is disadvantageous to Wrap accounts. We believe that the fixed fee should be divided by the average number of investment options that a client would hold.

- We are concerned about the risk of distortion for clients who have larger account balances, particularly where they may be eligible for fee reductions and rebates. As we understand it, this assessment is entirely based upon a $50,000 account balance, which is below the level at which fee reductions and rebates typically apply. We believe that this should be considered in the assessment methodology.

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- Section 9AB.4A of the draft regulation requires that with Lifecyle products, the highest RAFE should be used across all the different lifecycle versions. This could result in an entire product being assessed as underperforming, when only one option may be actually underperforming. This is unfair and needs to be corrected.
- Section 9AB.11(3) requires the inclusion of an assumed rate of tax. It should be noted however that with Wrap products, the tax impact is often lower, or deferred, as there is no allowance for CGT until the investment is actually sold. Thus, this requirement is likely to unfairly treat Wrap products, unless it includes an appropriate adjustment for the different tax treatment.
- Section 9AB.11(5)(b) requires the inclusion of the smallest actual return for a product with different investment pathways. This seems an unfair arrangement, particularly where there could be a range of different pathways, with a variety of different returns. This might arise as a result of there being an investment pathway with only a small amount invested. This might discourage the establishment of a new investment pathway. Trustees and investment managers may also be prevented from terminating a closed pathway as this may not be in the best financial interests of the members. This could mean that they are permanently disadvantaged. We recommend that each pathway is tested individually. Reducing the workload for APRA should not be justification for doing something that is unfair and could disadvantage consumers.

Conclusion

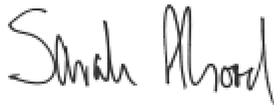
Whilst we are not opposed to the introduction of performance testing for Choice products, it is critical that the regime considers the impact on financial advisers and their relationship with their clients. It is also essential that it is fair and does not treat certain products in a way where the performance results are skewed.

We envisage that if this was implemented as proposed that it would have significant consequences for many financial advisers before the end of 2023, and then a huge impact when it is extended to all Choice products at a later point. There is a downside risk that needs to be considered, which is that it encourages some clients to make decisions to change products that might not ultimately be in their best interests. We are supportive of a message that encourages clients to consider the performance of their fund, but not one that scares them into making changes without accessing advice.

We also make the point that we fear that this regime will not only undermine client confidence in their adviser, but also confidence in the entire superannuation system. That would not be a good outcome.

The FAAA would welcome the opportunity to discuss the issues raised in our submission in more detail. Please contact me on 02 9220 4500 should you have any questions.

Yours sincerely,



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