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Annual Superannuation Performance Test – design options

The Property Council of Australia is proud to represent Australia's largest industry, representing nearly 13 per cent of national GDP ($234.7bn), and contributing over 18 per cent of total tax revenue ($106.1bn) across all levels of government. We champion the industry that employs over 1.4 million Australians, more than any other industry, and shapes the future of our communities and cities. Property Council members invest in, design, build and manage places that matter to Australians: our homes, retirement villages, shopping centres, office buildings, industrial areas, education, research and health precincts, tourism and hospitality venues and more.

The current performance test uses a formula to calculate a funds actual return to compare a benchmark return for each fund. Actual and benchmark returns are measured and weighted based on the asset class mix of each fund, and specific indices are used as benchmarks for every asset class. This essentially means that in practice, the performance of each asset class in a fund is measured against some sort of representative asset class index. Therefore, the Super Fund potential tracking error (i.e. deviation away from a benchmark) is impacted by the inclusion or exclusion of a particular asset class index. Super Funds are potentially discouraged away from investments that are not included within the representative index as this significantly increases their tracking error or essentially risk. As the single purpose test requires a focus on the Super Fund's members' best financial interest, the Super Fund will need to ensure there is a commensurate increase in return to balance the risk from an investment and a portfolio perspective.

The focus on asset level performance indices that roll up to an overall performance measure also fails to consider strategic asset allocation decisions at the fund level that are known to be some of the most important decisions towards achieving optimal total risk-adjusted returns.

This could lead Super Funds to put greater emphasis on strategic asset allocations and investment strategies that "track" the relevant performance indices – resulting in greater concentration of investment in assets or investments that reflect the relevant performance indices whilst potentially excluding other assets or investments that sit outside the indices. For example, the Australian Property benchmark (i.e. MSCI Australia) currently does not have exposure to residential housing. Therefore, a Super Fund that is investing in residential housing will inevitably experience an increase in tracking error (as the index performance made up of office, retail and industrial will perform differently to residential) and will therefore require a return premium to compensate until such time when residential housing becomes a larger component of the index.

The Property Council welcomes conversations if the proposed structure changes to a whole of fund level test, if the government seeks to change to a 'whole of fund' regime, the Property Council and our members will require additional consultation as each option, while solving some issues may create others. Therefore, this submission itself will focus on improving the current performance testing regime 'fixing status quo'.

Benchmarking issues

As discussed above, the Australian Property benchmark currently does not include an option to actively invest in domestic residential real estate. It is a missed opportunity as Super Funds may have a desire to diversify their property investments beyond the traditional sectors of office, retail and industrial property. Residential property has the potential to fulfil this desire, therefore supporting the Government's policy objective of increasing housing stock. This has been challenging, however, due to several very important reasons:

- Investing against the index, putting their performance at risk;
    - The lack of residential property in the index introduces risk to Super Fund performance if it chooses to invest in residential property;
    - As the institutional residential market remains in its infancy, Super Funds are required to invest via development of new buildings. The index itself is made up of low-risk, core, stabilised properties that provide income from the day of investment. Developing residential property will likely take years to complete and stabilise, therefore introducing a higher level of risk;
- Greater returns elsewhere .
    - Residential markets offshore are more mature, with established secondary markets that allows Super Funds to buy and sell residential properties efficiently, therefore reducing the cost of investment whilst improving capital allocation efficiency as it allows Super Funds the flexibility to invest in investments that suit its return and risk profile.
    - This contrasts with the Australian residential proposition that essentially requires a development strategy. Consequently, secondary market activity is immaterial and introduces a layer of risk that Super Funds may not be able to generate liquidity through the sale of residential housing.
- RG 97 including Stamp Duty

Investing against the index

Appropriate policy settings are needed to ensure that the superannuation system delivers on its intended goal of increasing the financial well-being of people whose savings are managed within the system. This includes assessing the performance of funds and identifying those funds that are markedly underperforming the broader industry – policy objectives which the Property Council supports.

However, the current design of the Your Future, Your Super (YFYS) performance test may in fact lead to poorer outcomes for Super Fund members and the Australian public. Given the Australian Property Benchmark focuses on core property assets, this can result in potential tracking error risks for:

- Investments in non-core commercial property such as data centres, childcare centres and importantly residential assets, such as social and affordable housing, Build-to-Rent housing, purpose-built student accommodation, aged care or NDIS accommodation.
- As a result, super funds are allocating capital away from these asset classes in Australia relative to other markets and are UNDERWEIGHT as a result.

Furthermore, investments in development or upgrading of assets given the higher risk nature of these activities is also avoided due to the risk/return dynamics.

Due to the negative implications if a Super Fund underperforms the proposed benchmark under the current performance test, it is essential that the benchmark is appropriately structured to take into account the underlying risks and returns of different asset allocations, and the benefits of a fully diversified investment portfolio.

The Property Council and our members have drafted a proposed solution that has been provided below.

Solution

The Property Council notes that both the Federal Treasurer and Housing Minister have been publicly calling for Super Funds to increase their investment in housing. While this has been difficult for Super Funds to execute due to the marginal nature of returns in the residential housing sector, particularly for affordable rental product which is by definition below-market rents, the tracking error risk presents an additional hurdle that must be accepted or overcome to enable such investments to occur. The Super Fund trustee's decision will therefore be weighed by the 'higher risk' of Australian residential property not just due to its absence in the YFYS benchmark but also by not having a commensurate return in order to achieve a balanced risk-adjusted return.

Applying a performance test at the 'Whole of Fund' level may remove some of these challenges and unintended consequences. Once a decision has been made, our members will be able to provide input as the introduction of different ratio's and comparisons may produce different issues. We would request further engagement to provide a targeted approach as our members ultimately, would like to help government improve the housing angle, based on the status quo.

International Benchmark

The current International Property Benchmark has a number of Issues:

1) It Is a customised benchmark that places an additional cost burden on Super Funds to access the benchmark. This seems to act counter to the Government's Intent to ensure Super Funds manage Its costs.
2) The benchmark Itself Is highly challenging. Despite the Government's Intent to Introduce a benchmark that Is global in nature, the current International Property Benchmark Is limited to the US, UK, Canada and counter-Intuitively, Australia. Notably, it excludes European and Asian funds.
3) The benchmark Is highly opaque. There have been general difficulties In receiving detailed Information In relation to the constituents of the benchmark. This creates challenges for Super Funds to build a robust understanding of the benchmark and therefore limits Its ability to outperform It.

The Property Council recommends looking to either GPFI or GREFI indices that are used globally across jurisdictions from Asia to Europe and Canada to measure international real estate performance. The timing obviously doesn't work for a 30 June cutoff, but if a 31 March was considered it would solve several issues.

Solution

The Property Council recommends looking to replace the current International Property Benchmark with the MSCI Global Property Fund Index which is commonly used by global property investors to measure international property performance. Notably, it will solve all Issues as listed above. The Property Council acknowledges, however, that the change to the MSCI Global Property Fund Index may result in a timing Issue. International property fund reporting tends to lag Australian fund reporting by over a month, leading to a potential timing mismatch between the Australian benchmark and the international benchmark when performance data is due for the YFYS reporting period. Members are not particularly concerned about the timing mismatch, however, if the timing Issue Is problematic for the Government, the Property Council is open to providing further guidance around potential solutions.

Greater Returns Elsewhere

The best financial interest's duty (BFID) forces funds to look for the best financial risk adjusted returns. The previous best interest's duty (BID) should be re-considered, allowing for a dual focus on delivering top financial returns but also looking holistically at the needs of the country. As the Governments own reports suggest, better retirement outcomes are delivered on home ownership status rather than purely relying on the balance of superannuation accounts. By shifting to a BFID scheme, there is now a narrower focus on 'financial interests' that potentially discourages trustees from deploying capital into areas of need in the economy including residential development, domestic build-to-rent (BTR) projects and sustainable investment strategies.

Regulatory Guide 97

The performance test consultation highlights the potential dislocation that can arise between distinct policy frameworks with competing policy objectives that apply directly and indirectly to the Super Fund industry.

A relevant case in point for superannuation is the interaction of the YFYS measures with ASIC's Regulatory Guide 97 (RG97) on Super Fund fee and cost disclosure.

RG97 was introduced with the intention of ensuring that Super Fund members have accurate information regarding Super Fund fees and costs to help their decision making in choosing superannuation products. The aim was to provide a consistent and transparent approach to fees and costs disclosure to issuers of certain superannuation products – again we have no concerns with the policy intent behind RG97.

However, in the property sector Super Funds are discouraged away from certain types of investments because of how RG97 accounts for them.

A prime example is the treatment of stamp duty under RG97. While state-based stamp duty is widely understood to be an **unavoidable tax**, it is recorded as a transaction cost under RG97 and therefore required to be disclosed. Given the significant quantum that stamp duty typically represents (e.g. generally 5% of transaction value depending on state), this can lead to some funds shying away from investing directly in property, even if the risk-adjusted return on the investment is higher than for other investments which don't incur stamp duty as a cost.

In contrast, stamp duty related to certain infrastructure investments is not disclosed for the purposes of RG97. This anomaly is caused by how RG97's interposed vehicle test and definition have been set, which puts direct property investments at a disadvantage to other types of direct investments in unlisted assets because the same types of costs don't have to be disclosed for those investments. Amongst other reasons, there is evidence that Australian Super Fund Asset Allocations are favouring Infrastructure over residential.

To give an example of the negative impact of defining stamp duty as a cost, several members have advised their real estate allocation has decreased since RG97 was introduced in 2017. Whilst it should be acknowledged that there were several other factors that may have influenced the reallocation away from property, RG97 played a significant role in creating hurdles in Australian property investments. If our members strategic asset allocation into property investments remained at the same level without decreasing, as at today, there would be millions of additional stamp duty revenue. The Property Council believes that this is a suboptimal outcome not only for Super Funds that invest In property, but also the property Industry (through lower capital availability) and local, state and the federal governments (through lower stamp duty receipts and lower capital availability to develop additional supply, particularly in residential housing).

Solution

Our members understand stamp duty is a taxation requirement, as well as several other state and federal taxes are required to be paid in Australia. We are not attempting to hide the transactions; we seek to have the **unavoidable tax** treated similarly as borrowing costs. Costs associated with borrowing are recorded and tracked, yet the important distinction is that they are also not attributed, lumped in as fees and costs.

Having stamp duty recorded and tracked gives transparency for all stakeholders while at the same time not distorting the market by including them in with fees. Fees are a competitive advantage for Super Funds, they can move and adapt to reduce fees. Taxes however are not adjustable. To reduce taxes, in this case, stamp duty the only option is to not purchase property. This outcome is not in line with either the priorities of both government and the Australian public's interest.

By collecting data on stamp duty and not including in the fee structure, the Property Council strongly believes a barrier for Super Fund investment in property is removed.

Conclusion

The Property Council and our members are committed to delivering the best outcomes for all Australians, both in retirement and through the living sector. We believe the best way forward is tweaking benchmarks to allow for greater investment in residential real estate. Amending the current requirement for RG97 to be included as a transaction cost when it is an **unavoidable** State based taxation measure, is another unintended policy design outcome that prevents investment. Taxation measures therefore need to be recorded as such and not reported as fees.

If you have any questions, please contact Matthew Wales, Policy Manager – Tax and Foreign Investment, at MWales@propertycouncil.com.au or on 0451 146 886.

Yours sincerely

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