2 May 2023

Director
Members Outcomes and Governance Branch
Retirement Advice and Investment Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: YFYS@treasury.gov.au

Dear Director,

Subject: Submission – Review of Your Future, Your Super Measures

We are pleased to provide this submission on the government's updating of the annual superannuation performance test in light of the issues raised in Treasury's review of the Your Future, Your Super laws.

WTW is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, WTW has 45,000 employees serving more than 140 countries and markets. We design and deliver solutions that manage risk, optimise benefits, cultivate talent and expand the power of capital to protect and strengthen institutions and individuals. In Australia, we provide actuarial, communication, technology and superannuation and investment services to a broad range of defined benefit and accumulation superannuation funds including standalone corporate funds, industry funds, master trusts, and master trust sub-funds.

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Changes to the Performance Test

At a high level, we believe that the majority of the proposed changes incrementally improve the effectiveness and fairness of the performance test. In particular, we support the extension of the performance test period from eight years to ten years and we support the majority of the proposed changes to benchmarks.

However, we continue to believe that the current approach, which is based narrowly on how well a fund implements an option's strategic asset allocation, has fundamental flaws in its efficacy and fairness. There have been a number of alternative approaches proposed through the consultation process and we recommend these be considered further.

We also retain significant concerns regarding the extension of the performance test from MySuper options to all Trustee-Directed Products ("TDPs"). Without reiterating in full the views we expressed in our previous submission, we continue to believe that the extension of the performance test to TDPs will have an adverse impact on innovation and choice for engaged members and that APRA already has sufficient powers to ensure the interests of choice members are protected.

In the remainder of our submission, we have focused on the performance test as it is currently broadly constructed.

Overall Comments on Benchmarks

While we believe that there are a number of improvements that could be made through broadening the proposed set of benchmarks, we recognise that the breadth of benchmarks is constrained in the short-term by the breadth of reporting within APRA Reporting Standard SRS 550.0 Asset Allocation ("SRS 550.0").

As a result, we have focused only on the current set of "covered asset classes" and the corresponding proposed benchmarks – though we believe there is significant scope to improve the benchmarks available if reporting is expanded in the future (particularly in fixed interest/credit). In the vast majority of cases, we believe that the proposed benchmarks are the most appropriate available. However, we believe that there are a small number of covered asset classes where improvements could be made.

Currency Exposure

The proposed set of benchmarks include a mixture of hedged and unhedged benchmarks for international equities, however other international asset classes, such as fixed interest, listed property and listed infrastructure, only include hedged benchmarks.

In our experience, most funds that implement currency hedging at the asset class level derive most, if not all, of their foreign currency exposure through equities, with other asset classes (particularly fixed interest) typically hedged. As a result, the proposed approach in relation to currency is likely to be adequate for funds that report their currency exposure at the asset class level (through hedging ratios for each asset class).

However, we believe that there is a flaw in the proposed approach to assessing the currency exposure of funds that manage their foreign currency exposure at the option level. Where funds report an option level exposure to foreign currency and, therefore, leave the hedging ratio for each underlying asset class blank, it is assumed that there is a consistent hedging ratio across internationally domiciled exposures to achieve the stated foreign currency exposure.

As an example, consider an option with the following exposures:

- International equities: 30%
- International listed property: 5%
- International listed infrastructure 5%
- International fixed interest: 10%
- Currency exposure: 20%

In this example, the option has a total of 50% invested in international asset classes and a currency exposure of 20%, with the result that each international asset class would be assumed to be 60% hedged.

However, no unhedged benchmarks have been included in the performance test for international listed property, international listed infrastructure or international fixed interest. This creates a significant mis-match between the level of currency exposure in the option and the level of currency exposure in the performance test benchmark for that option. In this example, the only currency exposure coming through in the benchmarks is from international equities (a 30% allocation), which is assumed to be hedged at 60%, resulting in just a 12% currency exposure, well below the actual target of 20%.

We view the potential level of mis-match, combined with the potential for significant volatility in currency markets, as a material risk to the efficacy of the performance test.

We propose the following alternative for funds that report currency exposure at the option level:

- Treat all international asset classes as hedged
- Treat the currency exposure as a separate allocation, with the benchmark for this allocation the difference between the unhedged and hedged versions of the MSCI All Country World ex-Australia Equities Index with Special Tax

This effectively assumes that all currency exposure is derived via equities and therefore also includes an inherent assumption that the starting point for the mix of currencies in an option's currency exposure is in line with the MSCI World ex Australia Index – we view this as a reasonable assumption based on our experience.

We also suggest that consideration be given to adjusting SRF 550.0 to allow funds that manage currency at the option level to provide more detail regarding the actual currency exposures they have (e.g. developed market v emerging market), which will provide more information for future performance tests.

Australian Fixed Income

The proposed benchmarks include a change in the benchmark for Australian Fixed Income from

- The Bloomberg Ausbond Composite Bond Index – which is comprised of nominal investment grade bonds ; to
- The Bloomberg Ausbond Master 0+ Yr Index – which is comprised of the Bloomberg AusBond Composite Bond Index (more than 80% of the index), but also includes inflation-linked bonds and floating rate notes

This change reflects feedback from the previous consultation process that the benchmarks available for fixed interest should be broadened to include allocations to other sub-asset classes, such as inflation-linked bonds and floating rate notes. While we understand the rationale for broadening the fixed interest benchmark used, we recommend reverting to using the Bloomberg Ausbond Composite Bond Index for the following reasons:

- The Bloomberg Ausbond Master 0+ Yr Index is not a widely used or recognised index
- The mixture between sub-asset classes (nominal bonds, inflation-linked bonds and floating rate notes) is not a natural starting point for investment, as each of these play different roles in a portfolio
- As far as we are aware, there are currently no investment products that target this benchmark. This would likely change if the benchmark were to be adopted, with some funds looking to reduce tracking error to the new benchmark, however this would represent a cost to the superannuation system in terms of transaction costs, with no obvious corresponding benefit
- Without any meaningful benefit from changing the benchmark, we believe it is preferable to maintaining consistency with the previous version of the performance test

We do believe that it would be an improvement to the performance test if **separate** benchmarks for inflation-linked bonds and floating rate notes were to be added in the future. However, we note that there would need to be a broadening in the reporting provided by funds to allow this to occur.

International Unlisted Property

The proposed changes to benchmarks include the introduction of a new benchmark for international unlisted property: MSCI Global (Excl. Pan-Europe and Pan-Asia Funds) Quarterly Property Fund Index (Unfrozen) (Net Total Return; AUD fixed).

While we support the introduction of an index for international unlisted property, we suggest that the more standard index, MSCI Global Quarterly Property Fund Index (with similar fee and currency adjustments), be used.

There are two key reasons for this:

- We believe it makes sense to use broader, more simple indices, where possible, as they represent broader opportunity sets and are typically more straightforward (and often cheaper) for funds to access
- We don't see a clear reason for excluding pan-European and pan-Asian funds, as these are a common way of accessing these markets and we expect them to represent around a quarter of the broader benchmark

Listed Infrastructure (International and Australian)

The proposed benchmark for listed infrastructure is the FTSE Developed Core Infrastructure 100% Hedged to AUD Net Tax (Super) Index.

We suggest replacing this with the FTSE Developed Core Infrastructure 50/50 Index, similarly adjusted for tax and currency.

While we typically support the use of market cap weighted indices (such as that currently proposed) for benchmarks, in the case of listed infrastructure, this results in a benchmark that is heavily biased to North America (more than 80%) and has high weights to more economically sensitive assets, whereas our suggested benchmark has a higher weight to assets with more "infrastructure-like" characteristics.

Given one of the roles of listed infrastructure in Australian superannuation funds is typically to provide diversification to the broader equities market, we favour an index that is less concentrated geographically and is more balanced in terms of underlying sub-sectors – including having higher weights to sub-sectors that are less economically sensitive and have more consistent cash flows.

Alternatives

We support the broadening of the benchmarks for Alternatives to allow for different levels of risk, through different benchmarks for Defensive Alternatives, Alternatives and Growth Alternatives and broadly the support the benchmarks to be used for these covered asset classes, noting that these types of investments are challenging to benchmark.

However, we suggest the use of cash, rather than global government bonds, for the defensive portion of each of these benchmarks, noting that global government bonds have significant duration exposure that is often not present in alternative assets.

Changes to Schedule 2A – Information Notice

In our view, the draft notice is a considerable improvement on the current version. The ability to show account balances at the previous 30 June rather than at the date of the notice is particularly welcome. However, there are some areas in which we suggest further changes.

Product References

The notice refers to "your superannuation product" several times. While this makes sense to members who hold only one product in the fund, in our view it could be misleading to refer to a single "superannuation product" where members may be invested in a range of investment choice options, only one of which failed the performance test. APRA's recently published Choice Heatmap demonstrated that while poorer-performing options were concentrated in a small number of funds, there were also some funds that only had a single poorly-performing option. While we appreciate the need for standardised text, in our view this needs to be balanced by the risk that insufficient flexibility could lead to members being misled.

YourSuper Comparison Tool

The notice refers members to the government's YourSuper comparison tool even where they do not hold a MySuper product in the fund. This paragraph makes no reference to the possibility that some MySuper products may also be underperforming products. It is important to remember that any member who holds a Part 6A product that is not a MySuper product must have made an active decision to do so. We therefore question whether referring them to a tool that does not cover the products they have actively chosen is appropriate. This is of particular concern where the member's existing products may have very different asset allocations and risk and return characteristics to available MySuper products.

In our view, it would be preferable not to refer to the YourSuper comparison tool until it has been expanded to cover non-MySuper products. At a minimum, in our view this text should be accompanied by additional warnings to the effect that their existing product may have a different investment strategy to any available MySuper product, that members cannot choose their preferred investment option in a MySuper product and that some MySuper products are also underperforming products.

References to Insurance

While the inclusion of references to a member's insurance in the draft notice is welcome, in our view those references are insufficient. Members need to be warned that moving super funds could have adverse consequences for their insurance cover – for example, they may need to serve out limited cover periods or be underwritten to obtain a similar level of cover in their new fund (and could potentially be declined for underwritten cover, leaving them uninsured or underinsured), they will pay different insurance premiums in their new fund, which could be higher than in their existing fund, and their occupation may be subject to restrictions or exclusions in their new fund. Further, there should be sufficient flexibility for trustees of employer-sponsored funds or sub-plans where employers fund the cost of insurance cover to warn members that they will no longer have the cover paid for in another fund.

Providing ASIC with Powers to Provide Relief

Finally, we would encourage the government to include in the draft regulation power for ASIC to relieve trustees of the obligation to issue the notice in situations such as an imminent successor fund transfer or wind up of their existing fund, and to include in the Explanatory Statement guidance on circumstances in which government considers this power should be exercised.

While we appreciate that it is not ideal for members to remain in underperforming products and acknowledge ASIC's view (in Report 729 released in June 2022, https://download.asic.gov.au/media/k1chrsc4/rep729-published-24-june-2022.pdf) that "information about the test failure will be relevant to a member's investment decision in relation to its superannuation product" (page 9), an influx of transfer requests could present considerable challenges for the transfer or windup.

For example, it will divert administration resources away from the transfer or windup; it could prompt complaints from members whose transfer request is received during blackout periods and so cannot be effected; in the case of small funds it could have implications for fee or other agreements with the receiving fund; and in a consent transfer situation it could prompt members to attempt last minute changes to the fund they have chosen as their new fund, thus delaying the windup of the fund.

We would be pleased to discuss this submission with you or to provide any further information required.

Yours sincerely

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