Superannuation Performance Test Regulations 2023

Aware Super Submission

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Executive Summary

Aware Super welcomes the opportunity to provide comment on the proposed changes to the regulations governing the Your Future, Your Super performance test.

We are supportive of the intent of the changes, including the extension of the test to Trustee-Directed Products (TDPs).

However, we are concerned that some of the proposals will not achieve their intent, and require further refinement.

This submission provides recommendations to:

- develop an appropriate review and consultation process in relation to performance test changes;
- improve the proposed benchmark indices to avoid inappropriate test outcomes;
- improve communications with members of failing products; and
- better meet the overall intent of the performance test.

We look forward to ongoing engagement with Treasury and the Government as the proposals are finalised.

About Aware Super

Aware Super has been the fund for people who value the community since 1992. We're one of Australia's largest funds and we're continuing to grow.

We merged with VicSuper and WA Super in 2020 and managed almost $146 billion in retirement savings for more than 1.09 million members as at 30 June 2022, including more than $30 billion in retirement assets. Our members—including teachers, nurses, public servants and emergency services officers—work in roles that support our community, and they expect us to do the same by investing in ways that do well for them, and good for all.

Recommendations

1. Improve consultation process for future reviews of benchmark indices, including:
    a. providing clear, published principles to guide the selection of indices and justifying proposed changes against these principles;
    b. providing sufficient time to review and assess the impact of proposed changes;
    c. Ensure that all proposed indices are available for review as part of future consultations.

2. Consider options to reduce the cost burden of monitoring benchmark indices, and provide trial access to new indices for the purpose of appropriate consultation.

3. Extend the lookback period for the performance test to 10 years.

4. Retain current Bloomberg AusBond Composite Bond 0+ Index for Australian Fixed Income.

5. Apply the Bloomberg Global Aggregate Corporate Index (hedged AUD) for International Credit, and consult further on any proposal to allow for a slightly more granular treatment of Credit.

6. Consult on a more appropriate International Property index.

7. Replace the proposed benchmarks for Alternatives, Defensive Alternatives and Growth Alternatives with 'cash plus' benchmarks.

8. Make any further changes to benchmark indices prospective, to ensure prior performance is not re-assessed to a differing standard.

9. Ensure that expansion/adjustment of the benchmark indices does not unfairly penalise legitimate investment strategies

10. Consider where additional granularity in data collected by APRA could support better performance test outcomes.

11. Allow grouping of Australian and International asset classes to prevent single-sector products being inappropriately captured as TDPs

12. Include property in the list of asset classes that can be grouped under Regulation 9AB.2(4)

13. Consider creating more nuanced consequence pathways to align with further expansion of the performance test.

14. Undertake member testing to refine the letter to ensure that it is understood and prompts the intended behaviour.

Feedback on draft regulations

1. Proposed changes to performance test

A more considered consultation process is required

Aware Super welcomes the recognition that adjustments to the original benchmarks underpinning the performance test are required.

However, consultation on the proposed changes has been rushed and there has not been sufficient time to fully understand the impact of the proposals, for individual funds or as an industry.

In relation to consultation on the benchmark indices, we note that:

- the four-week consultation period is insufficient to fully work through and understand the proposed changes; and
- not all proposed indices are currently available, and as such we have not been able to review them as part of this consultation.

Given the importance of the benchmark indices to funds' investment decisions, a standard review process should be implemented that allows for appropriate consultation and consideration of material changes to the performance test.

There should be clear principles in place to guide the selection of indices (for example, they should be relevant, available, and widely used by industry), and any proposed changes should be accompanied by an explanation of why the index has been suggested, with reference to these principles.

There is also a material cost associated with accessing and monitoring the benchmarks used in the test, which should be considered as part of any proposal to change benchmarks. At a minimum, index providers should extend trial access to indices that are under consideration for inclusion, so funds can provide meaningful feedback. More broadly, the ongoing cost of these indices, which are effectively compulsory for funds to subscribe to, should be considered and industry-level arrangements reached to reduce the cost burden where possible.

Recommendation
1. Improve consultation process for future reviews of benchmark indices, including: a. providing clear, published principles to guide the selection of indices and justifying proposed changes against these principles; b. providing sufficient time to review and assess the impact of proposed changes; c. ensure that all proposed indices are available for review as part of future consultations. 2. Consider options to reduce the cost burden of monitoring benchmark indices, and provide trial access to new indices for the purpose of appropriate consultation.

Extending the lookback period

Aware Super supports extending the lookback period for the performance test to 10 years.

This strikes the appropriate balance between providing a sufficient period to assess investment performance, without taking an overly long-term view that may poorly reflect current outcomes and punish products that have improved performance.

The lookback period should be aligned across the performance test, APRA heatmap assessments and the ATO comparison tool.

Recommendation
3. Extend the lookback period for the performance test to 10 years.

Proposed benchmark changes

While some of the proposed changes to benchmarks are likely to improve the accuracy of the performance test, some of the proposals seem unlikely to achieve their goal.

We recommend further consultation to resolve issues with several of the proposed changes.

For example:

- **Australian Fixed Income**
  - The proposed change from the Composite Index to Master Index has no clear rationale.
  - The Master Index is not a commonly used measure of performance, and requiring funds to track this more complex benchmark would increase transaction costs for no apparent benefit.
  - The current Composite Index should be retained.
- **Credit indices**
  - There is inconsistency between the use of an investment grade index for Australian credit and a High Yield (sub investment grade) index for international credit.
  - The Bloomberg Global Aggregate Corporate Index (hedged AUD) would be a more appropriate index.
  - Over the longer term, we would suggest that APRA's SRS 550 asset class classifications could be updated to provide a more granular solution to cover the expanse of Credit, which should ideally consider both investment grade and sub investment grade indices across fixed and floating rate structures to ensure that it (a) more appropriately captures well-established industry practice, and (b) avoids unintended consequences.
  - The fee assumption of 0.10% is significantly too low for a High Yield index. Given the high cost of managing a High Yield portfolio, 0.40% would be a more appropriate fee assumption.
- **International Unlisted Property**
  - The proposed MSCI index appears to include Australian funds, which should be excluded to avoid double-counting of returns.

- The index is unfrozen, which creates risk of survivorship bias and retrospective changes – in general, frozen indices should be the preferred option.
- It is not clear why the index excludes Pan-Europe and Pan-Asian funds, and the gearing level for participation in the index is significantly higher than is typical of Australian superannuation funds.
- We do not currently have access to the proposed index, so it is not possible to make detailed comments on its suitability.
- A more representative index should be developed, and an interim solution determined through further consultation.

- **Alternative assets**
  - The proposed methodology does not resolve the issues with the current approach to benchmarking alternative assets. The role of Alternatives in portfolios is usually to provide a source of returns uncorrelated to mainstream asset classes like equities and bonds. A benchmark constructed of these mainstream asset classes is therefore inappropriate as it will have significant tracking error to the strategies employed in this asset class.
  - A 'cash plus' benchmark would be more appropriate for alternative assets, with Defensive and Growth Alternatives having outperformance hurdles reflecting the risk employed. Consultation with industry around setting these levels would be helpful and we would be happy to provide our internal benchmarks for these asset classes.

Additional detailed comments on the proposed indices are included in Section 3 below.

Recommendations

4. Retain current Bloomberg AusBond Composite Bond 0+ Index for Australian Fixed Income.
5. Apply the Bloomberg Global Aggregate Corporate Index (hedged AUD) for International Credit, and consult further on any proposal to allow for a slightly more granular treatment of Credit.
6. Consult on a more appropriate International Unlisted Property index.
7. Replace the proposed benchmarks for Alternatives, Defensive Alternatives and Growth Alternatives with 'cash plus' benchmarks.

Changes to benchmarks should be prospective

The benchmarks underpinning the performance test will need to be updated from time to time. However, retrospectively applying a new benchmark over the testing period will retrospectively shift the goalposts for performance measurement.

This is unfair and may create confusion if it impacts whether funds pass or fail the test, and should be avoided.

We understand the rationale for applying the current changes retrospectively to align the choice and MySuper tests. However, going forward, benchmark changes should be appropriately managed to ensure they do not penalise funds who have managed according to the previous benchmark.

While the introduction of the test necessitated a retrospective assessment, this is not the case for future years.

This includes:

- applying new or changed indices prospectively – ie, managing all previous performance years based on the indices in force in the relevant year;
- providing appropriate time to review and consult on proposed changes to benchmarks (as above); and
- providing appropriate time to transition to new benchmarks where required.

Recommendation

8. Make any further changes to benchmark indices prospective, to ensure prior performance is not re-assessed to a differing standard.

Balancing granularity and complexity

While adding additional benchmarks can add granularity and accuracy to the performance test (if implemented appropriately), there are trade-offs to this approach in terms of adding complexity to the test. It is also not possible to have benchmarks in place that can reflect all legitimate investment approaches.

This complexity will only increase as the performance test is extended to choice accumulation products, particularly for products that are less likely to directly track the regulated indices such as those with Socially Responsible Investment (SRI) strategies.

If the test is further expanded to single-sector products, this issue will be further magnified as strategies that do not track the particular index used in the performance test will be penalised.

As we have noted in our previous submission, this issue can be resolved by providing a more nuanced consequence pathway for products that fail the test (see Section 2 below) rather than a bright line pass/fail scenario.

It is also worth considering how APRA's SRS 550 asset class classifications could be revised to provide more granular data where it would clearly improve the accuracy of performance test outcomes. For example, in the Credit asset class there can be significant divergence in performance depending on whether the strategy invests in fixed or floating rate assets, investment grade or below investment grade as well as regional differences.

Recommendation

9. Ensure that expansion/adjustment of the benchmark indices does not unfairly penalise legitimate investment strategies
10. Consider where additional granularity in data collected by APRA could support better performance test outcomes.

Grouping asset classes

Item 12 proposes treating certain asset classes as one asset class for the purpose of determining whether a product is to be treated as a TDP.

This is a sensible approach to balance granularity in the benchmark indices with the intent of the TDP definition.

To effectively achieve this outcome, an additional grouping should be added to ensure that single sector options which include both Australian and international assets are not classified as multi-sector products for the purpose of the test.

Property should also be added to the list of asset classes that can be aggregated for this purpose.

Proposed drafting is included at Section 3 below.

Recommendation
11. Allow grouping of Australian and International asset classes to prevent single-sector products being inappropriately captured as TDPs 12. Include property in the list of asset classes that can be grouped under Regulation 9AB.2(4)

2. Achieving the objective of the Performance Test

Consequences of failure

As highlighted in Aware Super's submission to the review of the Your Future, Your Super package, there is a material risk for even good funds that they will fail the test eventually through random chance, simply as a result of taking active risk.

This risk becomes magnified when expanding the coverage of the test, due to the potential for legitimate investment strategies of less diversified options to be mismatched against the chosen indices.

In this context, it would be appropriate to move away from a one-size-fits-all set of consequences for failure, and create more tailored pathways based on the circumstances of a product's failure.

This would minimise unintended behavioural responses from funds at risk of failing the test for reasons other than systematic underperformance.

While this should not create a situation where failures of the test are not acknowledged or addressed, it would reduce concern about imperfect benchmarks that do not align well with legitimate investment approaches.

Recommendation
13. Consider creating more nuanced consequence pathways to align with further expansion of the performance test.

Underperformance letter

While we were pleased to see some changes to the legislated letter for underperforming funds, further work is required to make the letter appropriately helpful for members considering how to respond to their products failing the test. Our experience in delivering member communications has shown to us the importance of member testing in formulating these messages to ensure that they are well understood, prompt the intended behaviour in response, and appropriately inform members of all key considerations when changing products. We would be happy to engage further on the process of refining the letter.

Recommendation
14. Undertake member testing to refine the letter to ensure that it is understood and prompts the intended behaviour.

3. Detailed comments on draft regulations

Reference	Issue	Proposed Solution
9AB.2(4A)	The proposed subregulation 9AB.2(4A) allows grouping of asset classes for the purpose of determining a TDP. Additional groupings are required to meet the intent of this section.	Replace the proposed subregulation 9AB.2(4A) with the following: *(4A) Despite sub regulation (4), for the purposes of subparagraph (2)(b)(i), treat the covered asset classes for a quarter listed in each of the following paragraphs as each being one covered asset class for the quarter:* *(a) the covered asset classes identified in items 1, 2, 3, 4, 5, 6 and 7 of the table in regulation 9AB.17;* *(b) the covered asset classes identified in items 8, 9, 12 and 13 of that table;* *(bc) the covered asset classes identified in items 16, 17, 18, 20 and 21 of that table;* *(cd) the covered asset classes identified in items 22 and 23 of that table;* *(de) the covered asset classes identified in items 24, 25 and 26 of that table.*
9AB.5A(4)-(7)	The benchmarks for Alternative assets remain inappropriate, despite proposed amendments.	Introduce 'cash plus' benchmarks for alternative assets.
9AB.17(7) **Item 13**	The proposed *MSCI Global (Excl. Pan-Europe and Pan-Asia Funds) Quarterly Property Fund Index (Unfrozen) (Net Total Return; AUD fixed)* index raises a number of concerns: • The index appears to include Australian funds. This creates double-counting of domestic property returns and issues with consistency in APRA reporting;	Consult with industry on development of a more appropriate unlisted property benchmark and interim arrangements.

	• The exclusion of Pan-Europe and Pan-Asian funds has no clear rationale; • The 60% gearing limit for participating funds is not reflective of Australian superannuation funds; • The index is unfrozen.	
9AB.17(7) **Item 16**	There is no clear rationale for changing the current Bloomberg AusBond Composite Bond 0+ Index. The proposal to use the Bloomberg AusBond Master 0+ Yr Index creates several issues: • The existing Composite index is the most commonly used index and more suitable for the performance test. - The Master index is not an index generally used by superannuation funds to benchmark portfolios. - The Master index was primarily designed as an measure of issuance, rather than to measure market performance. - The Master Index is a more complex benchmark, and tracking it will increase transaction costs (which are passed through to members). - Tracking the Master Index changes the risk-return profile of the index, which is generally used to monitor the performance of stable and predictable defensive assets. • The Master Index includes allocations to assets which are not appropriate, including: - Inflation Linked securities, which are rarely held by super funds (and super funds entering this market to reduce YFYS tracking error would cause significant distortions in this market). - Corporate floating rate notes, which are not generally grouped into the same asset class as they don't have any material interest rate duration, are a pure credit exposure, and are more illiquid.	Retain Bloomberg AusBond Composite index for Australian fixed income.

9AB.17(7) **Item 21**	The use of a High Yield index for international credit raises several concerns: • This is unnecessarily inconsistent with the corporate Investment Grade index used for Australian credit. • While we understand Treasury's approach is intended to provide flexibility, an investment grade index would be more representative • Use of a fixed rate, rather than a floating rate index or a combination, for sub investment grade credit does not reflect the range of sub investment grade exposures.	Replace the proposed index with Bloomberg Global Aggregate Corporate Index (hedged AUD), which will result in fewer unintended outcomes. Introduce additional granularity into APRA 550 asset class classifications to allow differentiation between different forms of credit.
9AB.17(7) **Item 21**	This only applies if a high yield index is chosen as the expression of international credit: the fee assumption of 0.10% for a high yield index is unrealistic, due to the cost of building and managing these portfolios – 0.40% would be a more realistic assumption but more consultation would be required to validate this.	Consult further with specialist managers before setting fee assumptions for any High Yield Credit index.