Willis Towers Watson

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Manager, Regulatory Framework Unit
Retirement Income Policy Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email: superannuation@treasury.gov.au

Dear Sir/Madam

Subject: Submission – Your Future, Your Super Regulations

We are pleased to provide this submission on the exposure draft of the Government's Your Future, Your Super Regulations and associated measures ("Regulations").

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This submission follows on from our submission presented to Treasury on 23 December 2020 on the exposure draft legislation and also our participation in a collaborative research effort between the Conexus Institute and five leading superannuation industry consultants, which resulted in submissions by the Conexus Institute on the exposure draft legislation, which we also supported.

In this submission we make further comments on the annual performance test as outlined in the draft Regulations.

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Our submission

As noted in our previous submission, we support the government's stated intention for the Your Future, Your Super package – in particular to ensure that funds are maximising net (after fees) returns for members.

However, we also noted that a single performance test is unlikely to achieve the government's objectives and we therefore proposed a number of improvements to the proposed test, which included:

- Use of more than just a single metric on which to assess the performance of a fund, including a metric that reflects the amount of risk taken by the fund to generate its returns; and
- Giving the regulator oversight of any decision to impose the most serious consequence (closure to new members) as a result of failing the performance test.

In our submission we also included as an Appendix a paper from the Conexus Institute which proposed an improved performance metric that made allowance for a fund's asset allocation decisions, by basing the benchmark for the test on the realised volatility of the fund's actual returns, rather than on its strategic asset allocation. This approach has the advantage of allowing for the impact of both asset allocation decisions as well as the quality of a fund's implementation in the test.

We note that the performance test, as currently proposed in the draft Regulations, "normalises" for risk, based on the fund's reported strategic asset allocation (SAA), but in doing so it does not reflect the amount of risk being taken (as a result of the SAA adopted). As a result, it is effectively only measuring the quality of the fund's implementation, based on the fund's performance (net of fees) *relative* to its agreed SAA.

This approach is only truly effective at assessing the quality of a fund's implementation if the performance test uses benchmarks or indices that reflect the underlying opportunity set that the fund is seeking to invest in within each asset class or category.

We believe that Treasury have effectively already recognised this principle by:

- Using different benchmarks for different asset classes (albeit initially based just on listed asset classes)
- Introducing new benchmarks for the two major unlisted asset classes that superannuation funds invest in (i.e. property and infrastructure.)

The second of these (the inclusion of benchmarks for unlisted property and infrastructure) laudably reflects feedback provided by the industry, that by not doing so, the risk of failing the performance test because of benchmark "noise[1]" creates a disincentive for super funds to invest in assets that support nation building and ultimately stronger economic growth.

Whilst the inclusion of the two additional indices results in an improved test for the effectiveness of a fund's implementation, we believe it could be improved further. In this submission, we have focused on the areas where we believe the introduction of additional benchmarks will have the greatest impact in further improving the efficacy of the test in assessing the quality of a fund's implementation – i.e. in the areas of Fixed Interest, Credit and Alternatives (currently labelled as "Other/Commodities".)

We note that historically, the data collected by APRA in relation to strategic asset allocations has not had sufficient granularity to distinguish between underlying investments within the Fixed Interest / Credit and Other categories. However, we also note that APRA Reporting Standard SRS 550.0 requires more detailed information regarding asset allocations (including collecting historical data on this basis) which provides the ability to much more accurately benchmark a fund's performance, and therefore to more effectively assess the quality of their implementation, by reducing benchmark noise.

[1] This "noise" is the tracking error or risk introduced as a result of the benchmark not representing the actual opportunity set that the fund is investing in. So for example, by introducing a benchmark for unlisted property that broadly represents the opportunity set that a super fund can invest in, the benchmark risk for a fund's investment in Australian unlisted property is considerably reduced compared to the previous position where the use of a listed property benchmark was proposed.

We provide specific recommendations for additional benchmarks in each of the three areas outlined below.

1. Fixed Interest

We believe that the current set of benchmarks for fixed interest are not sufficient for effective performance measurement and create a set of incentives and disincentives that may lead to poor outcomes for members.

We are particularly concerned about the potential for the narrow set of fixed interest benchmarks to stifle innovation that may lead to poor outcomes for members. While this is possible in MySuper portfolios, it is likely to have a more pronounced impact on lower risk 'trustee-directed options', to which the performance test is proposed to apply from 1 July 2022. These options typically have high allocations to cash and fixed interest, with Australian fixed interest measured against the Bloomberg Ausbond Composite 0+ Yr Index and International fixed interest measured against the Bloomberg Barclays Global Aggregate Index (hedged to AUD). These benchmarks have interest rate durations of around 6 years and 7.5 years respectively.

Benchmarks that encourage funds to reduce benchmark "noise" through investing in long duration nominal bonds could result in options which:

- Have an outsized exposure to duration – which results in risks to members' savings during periods of rising interest rates
- Are highly exposed to rising inflation – leading to the potential for significant erosion of members' purchasing power when they reach retirement
- Have higher cash exposures and lower bond exposures (in order to reduce duration) – resulting in lower returns to members.

We also note that a superannuation sector that is overly exposed to Australian interest rate duration increases the prospect of a greater reliance on the Age Pension (due to capital losses from bonds) occurring at the same time that Government borrowing costs are rising.

As a result, we recommend the introduction of three additional fixed interest benchmarks that cover:

- Inflation-linked bonds - the Bloomberg AusBond Inflation Government Index
- Short-duration bonds - the Bloomberg AusBond Composite 0-3 Year Index
- Long-duration bonds - the Bloomberg AusBond Composite 10+ Year Index.

2. Credit

A second concern we have is that superannuation funds typically have sizeable allocations to credit, which are often comparable in size to their allocations to infrastructure and property. However, while both infrastructure and property now have several benchmarks included in the performance test, currently credit investments are treated as fixed interest, meaning they are benchmarked against indices that include only investment grade bonds and which have a heavy bias towards government bonds.

As a result, for riskier credit such as high yield bonds, leveraged loans, emerging market debt and some securitised credit, there is a significant mismatch between the risk characteristics of the underlying investments and the benchmarks that they are being measured against. This creates two key issues:

- The efficacy of the performance test is reduced, as the opportunity set is not being accurately matched between the investments and the benchmark
- There are incentives for funds to over-allocate to credit investments in a bid to increase expected return relative to the performance benchmark, without being penalised for the additional risk being taken.

While the breadth of the fixed interest and credit universe makes benchmarking a more challenging exercise, we believe that modest changes to the proposed benchmarks would have a meaningful impact on the efficacy of the performance test. Specifically, we propose:

- Continuing to benchmark investment grade government and corporate fixed interest using the approach as outlined in the draft Regulations, but with the inclusion of the three additional benchmarks proposed in the Fixed Interest section above
- Adding one additional benchmark – the Bloomberg Barclays Global High Yield Index – that better matches the characteristics of the riskier types of credit described and which could be used for all credit investments that fall into the "Fixed Income Non-Investment Grade" category (asset class characteristic 1 under APRA Reporting Standard SRS 550.0)
- We believe that this is a pragmatic compromise which improves the benchmarking of risky credit without needing to introduce a unique benchmark for each sub-sector of the credit universe (i.e. it does not require a new benchmark for each of the high yield, leveraged loans, emerging market debt, and other sub-sectors.)

3. Alternatives

For alternative assets that are currently included in the "Other/Commodities" asset class, a 50/50 global equity / global bond benchmark is currently proposed.

Investments which would be included in this category are wide-ranging and include strategies such as:

- Hedge funds or skill-based strategies
- Strategies that aim to obtain exposure to "alternative" risk premia such as momentum, value, carry, volatility and others
- Strategies that invest in traditional asset classes, but which use a dynamic approach to manage the exposure to these, in the expectation of producing better risk-adjusted returns than a purely static approach
- Commodities.

All of these alternative assets are attractive to investors because they tend to be lowly correlated to the more conventional superannuation fund investments such as equities, unlisted assets and bonds and so they can play a very useful role in diversifying (and reducing) overall portfolio risk. If implemented effectively, this results in a smoother pattern of overall fund returns, which has clear benefits for members as they approach and enter their retirement years.

A key metric in determining the diversification benefit provided by such strategies is their sensitivity or "beta" to global equities. Typically, the beta of such strategies is less than 0.5; but by comparing them to a benchmark that comprises 50% global equities (and 50% global bonds) they are effectively being compared to a benchmark that has an equity beta of 0.5. The implication is that such strategies would then need to generate a return equivalent to their benchmark with a 50% equity weight in order to reduce the risk of underperforming this benchmark. However, for alternative assets with an equity beta of less than 0.5, this is a difficult benchmark to beat and so the net effect is that the benchmark currently proposed acts as a disincentive for investors to pursue strategies that provide strong diversification benefits (because of their low equity beta.)

Whilst there is no single benchmark that is suitable for all assets that fall into the Alternatives category ,for simplicity reasons we suggest that a combination of global equities and cash[1] is a suitable starting point, but that the mix needs to be adjusted to reflect the beta or sensitivity to global equities of the actual investment. For example, a skill-based strategy may have an equity beta (based on an ex-ante assessment) of 0.2, in which case a benchmark made up of 20% global equities and 80% cash would be more appropriate than the current benchmark.

[1] We suggest the use of cash rather than global government bonds, as global government bonds have significant interest rate duration risk that is often not present in alternative assets that have a low equity beta. However, it is possible that in addition to specifying the equity beta for an alternative asset, a fund could also specify the most appropriate cash or government bond index to be used in the benchmark.

Whilst this introduces an element of subjectivity into the selection of the appropriate benchmark for each investment in the "Other" category; responsibility for determining the appropriate mix could be given to the Trustee, with confirmation to be provided by the fund's asset consultant and / or the Regulator.

We believe that in order for this approach to work, one additional statistic would need to be reported to APRA – i.e. the estimated beta to global equities of the investment. We believe that it should be possible to include this in the reporting proposed under APRA Reporting Standard SRS 550.0.

As an alternative, a broader range of indices for the "Other" category could be introduced, ranging from 100% equities / 0% cash through to 0% equities / 100% cash, in increments of 25%. This would result in five benchmarks for the "Other" category and would allow a fund to select the most appropriate benchmark for each investment in this category.

Whilst the approach outlined above may lead to concerns that super funds will 'game' the system, in reality this potential already exists – funds wishing to outperform the existing benchmark for the "Other" category are incentivised to invest in strategies that have an equity beta of more than 0.5 (i.e. by investing in strategies with a higher correlation to global equities); or, if their existing strategies have a beta to equities of less than 0.5, to avoid investing in these altogether (to avoid the risk of benchmark underperformance). Either way, the potential diversification benefits of these strategies are likely to be reduced, compromising the overall effectiveness of the overall portfolio outcomes.

We believe that this approach, whilst not perfect, will result in the risks members are exposed to from Alternative investments being more accurately reflected in the benchmarks used, thereby improving the efficacy of the performance test in assessing the quality of a fund's implementation.

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We appreciate the opportunity to contribute to the development of this important policy issue. We would be very pleased to discuss this submission with you or to provide any further information needed.

Yours sincerely

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