Your Future, Your Super review

Aware Super Submission

October 2022

Issued by Aware Super Pty Ltd ABN 11 118 202 672 AFSL 293340

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Executive Summary

Aware Super welcomes the opportunity to provide feedback on the operation of the Your Future, Your Super package.

Given the magnitude of these reforms, it is appropriate to consider whether the measures appear to be achieving their stated objective, and whether those objectives are the right ones to take forward as the reforms are embedded into the industry.

This submission focuses on Aware Super's observations relating to the annual performance test and the YourSuper comparison tool.

We have identified several areas where there could be improvements in the operation of these measures, with a focus on areas where there may be adverse impacts on member outcomes.

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 manage approximately $150 billion in savings, including $32.6 billion in retirement assets at 30 June 2022. 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.

Summary of recommendations

1. Review and revise benchmark indices to ensure that they do not penalise legitimate investment strategies.
2. Consider providing an appropriate CPI+ benchmark for asset classes where there is not an appropriate benchmark.
3. Address the inappropriate disincentive to mitigate risk for appropriate cohorts.
4. Regularly convene a working group of technical experts as part of ongoing monitoring of the suitability of indices.
5. Extend the lookback period for the performance test and YourSuper tool to 10 years.
6. Weight lifecycle stages by time, rather than FUM, to provide a clearer picture of actual member outcomes.
7. Allow APRA discretion to consider the context of a product's failure of the Performance Test, and apply consequences proportionally.
8. Do not extend the current performance test methodology to retirement products.
9. Commence a separate process to develop an appropriate framework to assess the performance of retirement products.
10. Ensure communications relating to product underperformance can be appropriately tailored to the circumstances of a product's failure and next steps, including where an SFT is imminent.
11. Adjust the YourSuper tool so that the default sort is by net returns, rather than fees.
12. Identify and include an appropriate risk metric or filter as part of the YourSuper tool, to support consumer decision-making.
13. Provide clear information about insurance for individuals considering switching funds.
14. Address existing issues with the YourSuper tool before considering extending it to other product types.

Response to consultation paper

1. Performance test

Objective of the test

It is vital to ensure that the objectives of the performance test, and its consequences, are well understood and that the test can be measured against these going forward.

From a MySuper perspective, if the initial goal of the Test was to identify persistently underperforming funds and ensure they exit the market, this has largely been achieved.

However the Test has mainly improved member outcomes through underperforming funds exiting the market, rather than through members proactively leaving underperforming products. This suggests that, while disclosing poor performance is worthwhile, relying on members to actively switch products is an inefficient way to improve outcomes.

In this context, there should be consideration of whether the test is designed effectively to ensure good member outcomes across the industry over the longer term, and whether a more nuanced approach is required to support this.

If the objective of the test is to protect members from poor superannuation products, then the experience to date suggests that the test methodology and consequences should be refined to ensure that they are achieving the desired outcome.

The objective of the test will drive the test methodology, coverage and consequences, so it is important this is clear.

Test methodology

<u>Benchmark indices</u>

The Test is designed, at a basic level, to measure the effectiveness of a fund's investment strategy.

However, the reliance on benchmarking against a set of existing indices means that even a good long-term investment strategy can result in a failed test, where the indices are not representative of fund strategies or underlying investments.

For example, the infrastructure benchmarks do not reflect the return profile of clean energy infrastructure, because the index is heavily weighted to fossil fuels. This effectively means funds are taking on extra risk when making these investments, even if the asset offers a return profile that is attractive to the fund.

These benchmark mismatches impact on funds investment decisions, and are a significant barrier to funds increasing their investment in the energy transition. The need to manage active risk against these indices also conflicts with funds' obligation to consider climate risks as part of their investment strategy.

Other types of assets where there may be material mismatch issues include fixed income, defensive alternatives, and emerging markets. Alternative benchmarking approaches, whether this is the addition of more appropriate indices, an adjusted index or an appropriate CPI+ benchmark, would help to address the benchmark mismatch issues.

However, we would caution that the need for more appropriate benchmarks must be balanced with the fact that having a large number of indices will add significant additional complexity.

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

It will be vital that there are mechanisms in place, both through refining the list of indices and through managing failure of the primary performance test, to ensure that products with specific investment approaches are not unfairly penalised where they are still delivering appropriate consumer outcomes.We would be pleased to provide additional feedback on specific proposed changes to the benchmarking approach for impacted asset classes.

Impact on investment decisions

Whether or not it was intended, there is significant evidence of funds making investment decisions with the performance test in mind, particularly due to the benchmark mismatches noted above. While this is not an issue if it results in better member outcomes, there are instances where funds have made decisions that may have resulted in poor member outcomes.

For example, the test disincentivises the use of risk mitigation strategies and overlays, even where these are in the best interests of members (for example, members in an older cohort where preservation of existing savings and managing sequencing risk is particularly valuable).

Risk is not only managed through a fund's strategic asset allocation, but also via specific exposures within asset classes. Failing to account for this means the test inappropriately penalises intra asset class strategies that involve risk management.

This could be addressed through the performance test, or on a case-by-case discretionary basis where a product fails the test due to having a risk management approach that is appropriate for the membership.

Ongoing monitoring of indices

It will also be important to regularly review the indices used to benchmark performance, and consult with industry on an ongoing basis around their operation. This will ensure benchmarks remain relevant and also serve as an "early warning" system if there are any mismatches that become problematic.

A standing group, similar to the technical working group convened as part of the current Review, could convene 1-2 times per year to identify any emerging issues which might impact fund performance against the indices and any appropriate action.

Lookback timeframe

The current eight year window for measuring performance is arbitrarily short. Aligning with data being available, it would be appropriate to lengthen to a 10 year performance lookback period.

This would align the performance test with standard performance reporting horizons, and would assist in mitigating the impact of some of the benchmarking issues identified above.

This 10 year horizon should be extended to the YourSuper tool for consistency.

Lifecycle strategies

The current approach of weighting lifecycle strategies by funds under management (FUM) in each stage is not appropriate. This approach means the same lifecycle design could end up with different test outcomes depending whether it has a younger or older demographic profile. It is more appropriate to weight each stage based on the time a member will spend in that stage.

Measurement of lifecycle products should be based on the structure of the lifecycle design, which is what drives long-term performance outcomes for members. Good lifecycle structures can materially improve outcomes at retirement relative to static options, while bad structures can impair them. This aspect of the investment strategy should be incorporated into the nature of the performance test.

Recommendations

1. Review and revise benchmark indices to ensure that they do not penalise legitimate investment strategies.
2. Consider providing an appropriate CPI+ benchmark for asset classes where there is not an appropriate.benchmark
3. Address the inappropriate disincentive to mitigate risk for appropriate cohorts.
4. Regularly convene a working group of technical experts as part of ongoing monitoring of the suitability of indices.
5. Extend the lookback period for the performance test and YourSuper tool to 10 years.
6. Weight lifecycle stages by time, rather than FUM, to provide a clearer picture of actual member outcomes.

Consequences of failure

Given the low failure rate in the second year of the MySuper test, it can reasonably be expected that the number of products failing each year will continue to be small (noting that the expansion of the test to choice products will significantly increase the number of products being tested).

There is also 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.

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.

A trustee with a product that has failed the test should have the opportunity to provide additional information to APRA, either before the test or within a reasonable timeframe, to inform APRA's response.

Considerations which could be taken into account when considering the appropriate regulator response to a failed test include:

- whether the product has previously failed;
- the quantum of the failure beyond the 50bp threshold;
- the headline returns of the product;
- the reason for the failure – for example, in situations where:
    - a benchmark mismatch may cause a failure that may not have otherwise occurred (and may cause multiple failures);
    - an investment strategy should be measured against an alternative benchmark;
    - a risk overlay or other strategy that can be shown to be appropriate for a product's membership has caused underperformance.
- whether the trustee can sufficiently demonstrate that issues with investment strategy leading to the failure have been corrected and performance going forward will not be impacted.

These additional factors should be robustly assessed by APRA through examination of evidence provided by funds.

This may involve secondary tests where appropriate, such as in the proposed secondary test for faith-based funds, which could also be relevant for Socially Responsible Investment options that do not track to the regulated indices.

Importantly, this approach should not create a system where failures of the primary test are not acknowledged or addressed.

However, creating clear approaches to managing consequences for failure in different circumstances will help ensure that products which are delivering good member outcomes are not treated unfairly. This will ensure the assessment process can provide proportionality in response to failure, without removing the 'bright line' assessment approach.

While the original consequences for failure (informing members and closure of the fund to new members) should be maintained where these are appropriate, APRA should have the discretion to apply alternative consequences or moderate consequences where they may not be appropriate.

For example, if a fund is able to demonstrate that current member outcomes have improved and issues causing failure are historical, APRA should have the discretion to allow products to remain open following a second failure.

For example, it may be appropriate to amend member communications or, in circumstances such as where a merger is already underway for a failing product, it would be appropriate to provide exemptions from sending the regulated member letter.

Recommendations

7. Allow APRA discretion to consider the context of a product's failure of the Performance Test, and apply consequences proportionally.

Product coverage

Aware Super has strong reservations about proposals to extend the current performance test to retirement products.

The current test, with its singular focus on performance, cannot appropriately measure the performance of retirement products, including innovative income stream products. Applying the current test would directly conflict with the requirements of trustees under the Retirement Income Covenant to balance the three key objectives of income, risk and access to funds.

We do not object to the assessment of retirement products, but more work is required to ensure that this can be done in a meaningful way that considers the differing goals of members in retirement.

We would welcome the opportunity to work with Government, Regulators and industry to develop an appropriate framework for assessing retirement products which aligns with the Retirement Income Covenant objectives.

Recommendation

8. Do not extend the current performance test methodology to retirement products.
9. Commence a separate process to develop an appropriate framework to assess the performance of retirement products.

Communicating performance outcomes to members

The approach of regulating a standard letter to be sent to members in poorly performing products should be reconsidered.

This is because:

- the relatively low number of members in underperforming funds who proactively switched products after receiving the regulated underperformance letter indicates that it has had limited impact;
- the letter does not allow flexibility to tailor key information in circumstances such as where a fund is in the process of merging and an SFT into a high performing fund is imminent – this is likely to result in confusion for members;
- the letter as drafted does not provide important information, including acknowledgement that individuals should consider their insurance cover as part of any decision to switch funds;
- the current drafting is not appropriate or useful for communicating with members in choice products and options, particularly where these members may be advised or have multiple options within their account.

A more flexible approach to member communications would align with the proposal above to consider several alternative pathways to address failing the test.

It is appropriate for the regulations to refer to some key information which should be included in member comms, but flexibility to provide tailored (but not misleading) communication would improve member understanding.

Recommendation
10. Ensure communications relating to product underperformance can be appropriately tailored to the circumstances of a product's failure and next steps, including where an SFT is imminent.

2. YourSuper comparison tool

Default sort settings

Currently, the default view for the YourSuper tool shows products sorted from lowest to highest fee. This suggests to users of the tool that low fees are the most important thing to consider in choosing a super fund.

While fees are important, it would be more appropriate and useful for consumer, if the tool automatically sorted products by net return.

The net return metric already includes fees, and is more reflective of the actual outcome a member will be getting from a particular option.

Recommendations
11. Adjust the YourSuper tool so that the default sort is by net returns, rather than fees.

Communicating risk

While it is important to keep the YourSuper tool simple and accessible, the tool currently does not provide sufficient context around key issues such as risk.

While the level of investment risk inherent in a product is of less concern to a younger individual, it may be a significant consideration for an individual close to retirement.

With no ability to consider risk as part of the comparison process, it is difficult for individuals to know whether they are making a choice that is right for them.

This is particularly relevant when comparing lifecycle products to single-strategy products. The current layout makes it difficult to understand why returns on a lifecycle product's older cohorts may differ, and why that is the case.

While communicating risk to consumers is difficult, it is still necessary to ensure it is appropriately considered when comparing products.

Further consideration should be given to how risk can be communicated to relevant users of the tool, and consumer testing undertaken with relevant cohorts.

Recommendations

12. Identify and include an appropriate risk metric or filter as part of the YourSuper tool, to support consumer decision-making.

Insurance

The YourSuper tool currently does not make it clear to users that switching funds could impact any existing insurance coverage.

We acknowledge that providing insurance information for each product could add complexity that makes the tool more difficult to use. However, at a minimum, a prominent warning should be provided to ensure that individuals are aware of the need to consider insurance coverage as part of any decision to switch superannuation products.

Recommendations

13. Provide clear information about insurance for individuals considering switching funds.

Coverage of the tool

Any extension of the YourSuper tool beyond MySuper products should include consideration of how this will impact consumer decision-making.

Adding choice accumulation products to the current tool, without additional information or context, is likely to lead to confusion and make decision-making more difficult. The issues identified above should be resolved before any additional product types are added to the tool.

In general, the YourSuper tool should be structured to steer choice toward MySuper products, as these are likely to be the most suitable products for most individuals.

Extending the existing YourSuper tool to retirement products would not provide useful comparison information to consumers, given the tool is focused on fees and returns rather than income. Any consideration of a comparison tool for retirement products cannot progress until appropriate performance metrics for these products are developed and implemented.

Recommendations

14. Address existing issues with the YourSuper tool before considering extending it to other product types.