

14 October 2022

Superannuation Efficiency and Performance Unit
Retirement, Advice and Investment Division
Treasury
By email to: YFYS@treasury.gov.au

Dear Sir/Madam

Vanguard Super Pty Ltd and Vanguard Investments Australia Ltd (together, **Vanguard Australia**) welcome the opportunity to make this submission to the Your Future Your Super (**YFYS**) Review.

About Vanguard

In Australia, Vanguard has been serving financial advisers, retail clients and institutional investors for over 25 years, with Australia being the longest-established presence for Vanguard outside the US. During this period, Vanguard Australia has been a major provider of low-cost investment management services to all segments of the Australian superannuation industry, as well as to the broader institutional, exchange traded fund and retail wealth management sectors.

Vanguard Australia first announced its intention to enter the superannuation market in late 2019. In August 2022, Vanguard Australia was granted a superannuation license to operate as a Public Offer Registrable Superannuation Entity licensee and is currently in the final stages of preparing to launch the superannuation offering to the public.

Vanguard Australia supports the principles and intent of the YFYS reforms and believes increased transparency and benchmarking of funds against their stated asset allocation provide significant benefits to superannuation members.

We have set out our views below on the operation of YFYS to date, including matters which we believe should be considered in the future expansion of YFYS.

Performance test

General comments

As an overarching principle, Vanguard Australia supports the core foundation of the performance test, being independent performance benchmarking of accumulation-phase investment options, most particularly those operating as MySuper products.

Measurement of performance against a custom passive reference benchmark comprised of investible benchmarks allows trustees' investment decisions to be appropriately scrutinised against an objective measure to determine the effectiveness of those decisions and the outcomes delivered to members.

In our view, the outcomes of these decisions (net of the additional costs that they invariably entail) should only be adopted by trustees if they are expected to deliver superior returns to members over reasonable time periods compared to a simple, passive execution of the same strategic asset allocation. We believe investment strategies that fail to achieve this goal (especially within a margin of 50 basis points per annum) should be assessed as underperforming.

The YFYS Review paper notes the performance test was designed to protect members from underperformance by holding trustees accountable for the investment performance they deliver and encouraging trustees to reduce fees.¹

Vanguard Australia has long supported the independent and objective assessment of investment performance, including measures to remove the tail of underperforming products. Our previous submissions to both the Productivity Commission² inquiry and the YFYS legislative package³ supported these significant reforms to superannuation, which we believe are critical to strengthen regulatory oversight and trustee accountability for the investment performance delivered to members.

In the following sections, we provide our feedback on the performance test methodology, the consequences of failure, and areas for consideration when extending the performance test past MySuper products to trustee-directed products and beyond.

Test methodology

We reiterate our support for the assessment of investment performance against a custom passive reference benchmark comprised of investible indices. As previously advocated⁴, we consider this to be best suited to assess individual products and funds.

¹ Your Future Your Super Review, *Consultation Paper*, p.4

² Vanguard Investments Australia, [Submission to the Productivity Commission's Draft Report: Superannuation: Assessing Competitiveness and Efficiency](#)

³ Vanguard Investments Australia, [Submission to the Your Future Your Super legislative package](#)

⁴ Vanguard Investments Australia, [Submission to the Your Future Your Super legislative package](#)

As a principle, investment options should be able to perform against passive policy benchmarks based on their own stated asset allocation.

Whilst we are aware of suggestions for alternative approaches such as "CPI-plus" or "risk-adjusted" measures using quantitative risk ratios, we do not believe any of these alternatives are suitable or provide a robust, appropriate benchmarking approach. It is our view that a clear, objective 'bright line' approach is the best policy framework for performance testing, and that the passive reference benchmark assessment approach currently in place appropriately fills this criterion.

Testing period

The current MySuper performance test is conducted over a period of eight years. We understand this is in alignment with the availability of detailed MySuper investment performance data from its commencement in 2013; however we consider that, as the longitudinal data deepens over time, this period should be reviewed and extended.

We note the Productivity Commission suggested that rolling 8-year returns are "reasonably predictive of longer-term performance" based on their analysis, which found that all MySuper products that underperformed over the longer period used for their benchmarking (11 years) would have also failed an eight-year performance test⁵.

However, the Productivity Commission also found some products which did not underperform over the long term would have failed an eight-year performance test.⁶ It suggested more granular asset allocation data and more specific indices in the benchmarks would likely correct these abnormalities, however this has not yet transpired. Accordingly, we submit this issue remains, reducing the efficacy of the test and its relevance as an accurate measure of long-term performance.

The Productivity Commission also found that the results of their performance analysis were most sensitive to the time period analysed, ahead of other factors such as hedging ratios, asset allocation, or tax adjustments⁷.

Vanguard Australia believes that a 10-year testing period would be more reflective of the long-term nature of superannuation and would be more appropriate to assess the performance of investment strategies usually employed by superannuation trustees for their MySuper products.

⁵ Productivity Commission, *Inquiry report – Superannuation: Assessing Efficiency and Competitiveness*, p.146

⁶ Productivity Commission, *Inquiry report – Superannuation: Assessing Efficiency and Competitiveness*, p.146

⁷ Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness*, Technical Supplement: Investment Performance Methodology and Analysis, p1

Further, a 10-year period would align with the statutory requirements⁸ for MySuper products, such as consumer disclosure through the MySuper dashboard and product disclosure statements, which are over a 10-year period.

Whilst sufficient investment performance data does not yet exist for MySuper products, it would be reasonable to adopt a similar approach to the first two years of the test (which commenced with a seven-year performance test in 2021, increasing to eight years in 2022). Under this transitional approach, we submit that a nine-year performance test should apply to the 2023 MySuper performance test, increasing to 10-years in 2024.

When considering the extension of the performance test to Choice options, we submit there is no reason why the test should not be conducted over a 10-year period. This is important to the extent that some Choice investment options utilise higher-risk investment strategies which may underperform an eight-year test that is not appropriate for the nature of those products, their investment strategies, or the way those investments are intended to be used by members.

Consequences

The consequences of failing the MySuper performance test comprise three components – the publication of results by APRA, written notification to members in the product encouraging them to move to a different product, and restriction to new membership upon two consecutive years' failure.

We believe these consequences are generally appropriate for MySuper products which fail the performance test in the context of their status as default superannuation products for individuals who do not select a fund, the largely homogenous structure of MySuper products (which is mandated by law⁹), the nature of MySuper members and their lower levels of engagement with their superannuation, and the ways MySuper products are used (often as the sole investment option in an individual's account).

Given these factors, which often do not include members making an active choice in respect of their superannuation, we support the current consequences of failing the performance test as important member protection measures for disengaged members.

We believe it is appropriate for underperformance to be directly communicated to affected members and, given the disengaged nature of MySuper members and the default status of MySuper products, we support persistently underperforming MySuper products being closed to new members.

⁸ *Corporations Regulations, r7.9.07S & APRA SRS 700.0 MySuper Product Dashboard*

⁹ *Superannuation Industry (Supervision) Act 1993, Part 2C*

However, the significant consequences of the existing performance test are not necessarily appropriate for all types of products. We believe the consequences should be considered in the context of the type of product being tested, the nature of its membership, and the way it is used by members. These matters are discussed in further detail in the following section on product coverage.

Product coverage

In our view, all accumulation investment options should be subject to independent performance assessment and any well-constructed investment option should be able to meet an appropriately designed performance test.

However, we believe it is important to ensure that any Choice performance test (including its consequences) is appropriate for each type of investment option, the nature of its members, and how these options are used in a member's portfolio.

The benchmarks used to assess performance should be appropriate to the variety of underlying investments utilised in Choice investment options, as otherwise the performance test may not provide an accurate reflection of an option's performance. However, we do not believe the benchmarks utilised for the Choice performance test should be overly complex or granular.

Differentiating factors between MySuper and Choice

As the performance test is expanded to trustee-directed products and more broadly to other Choice investment options, it is important to acknowledge the nature of Choice options and members when determining the appropriate approach to performance testing, including the consequences of failing the test.

Since 1 July 2014, MySuper products have been the only available vehicle for employers to make default contributions. Reflecting their status as default products and the often-disengaged nature of default members, MySuper products are constructed based on distinct provisions in legislation¹⁰ which set out specific requirements for a MySuper product's investment strategy, consistency of features and benefits, and fee charging rules. In addition, MySuper products are subject to greater regulatory oversight by APRA through the separate APRA licensing process which exists for MySuper.

Unlike the homogenous nature of MySuper products and their default members, Choice members are inherently more engaged with their superannuation. A member cannot enter into a Choice investment option without having made an active choice to select a product outside the default.

¹⁰ *Superannuation Industry (Supervision) Act 1993*, Part 2C

Whilst MySuper products are often the only investment option applicable to a member's superannuation account, Choice options are generally used by members as building blocks of a broader diversified portfolio. This could include the use of multiple single sector options, multi-sector options, deliberate splitting of holdings across two or more superannuation funds, or a combination thereof.

Interaction with existing regulatory regimes

We believe the extension of the performance test to Choice investment options should be considered alongside other regulatory measures. We note these requirements were either not in place¹¹ or have been substantially modified¹² since the time of the Productivity Commission's review and recommendations.

APRA Superannuation Prudential Standard *SPS 530 Investment Governance* (**SPS 530**) sets out requirements for trustees to formulate specific and measurable investment objectives for each investment option (including return and risk objectives), have in place an effective due diligence process for the selection of investments, monitor and assess the performance of investments on an ongoing basis, and review the investment objectives and investment strategies on a periodic basis.¹³

The design and distribution obligations contained within the Corporations Act (which do not apply to MySuper products) require trustees to make determinations in respect of their products to ensure they are designed for and only distributed to members who meet specific characteristics, as set out in each product's target market determination.¹⁴

ASIC also has product intervention powers that enable it to make a product intervention order when a product has, or is likely, to result in significant consumer detriment. This is available without a demonstrated or suspected breach of the law, allowing ASIC to take action before significant detriment is done to consumers.¹⁵

Under APRA Prudential Standard *SPS 515 Strategic Planning and Member Outcomes* (**SPS 515**), trustees are required to undertake an annual outcomes assessment which determines whether the financial interests of members are being promoted by the trustee. We note APRA is consulting on modifications to SPS 515, including addressing underperformance even where the product has not failed the performance test. This will further strengthen the member protections provided by SPS 515.

As further required by superannuation law¹⁶ trustees are also required to undertake product comparisons and benchmarking. This includes comparisons of net investment

¹¹ *SPS 515, Design & Distribution Obligations, Product Intervention Powers*

¹² *SPS 530*

¹³ *SPS 530, Objectives and key requirements, p.1*

¹⁴ *Corporations Act 2003, Part 7.8A & ASIC RG 274 Product design and distribution obligations*

¹⁵ *Corporations Act 2003, Part 7.9A & ASIC RG 272 Product intervention power*

¹⁶ *Superannuation Industry (Supervision) Act 1993, s52(9)*

performance, investment risk, fees and costs, and other metrics, all of which must be considered in both absolute and relative terms.

The existence of these existing regulatory frameworks does not decrease our support for an independent performance test to be conducted for all accumulation superannuation investment options. However, we submit these factors may be useful to consider when determining the appropriate consequences of failure in the context of existing regulatory levers available to address underperformance.

Hierarchy of consequences

Given the different nature of Choice investment options, their members, and the regulatory framework which applies to Choice products, we believe the key principle for Choice performance testing should be ensuring the test is appropriately constructed and the consequences which apply to failing a Choice performance test are appropriate for the products and their members.

Vanguard supports accountability and transparency, and believes the test results should be published by APRA regardless of the product type. We note a similarly transparent approach already exists for the APRA Heatmaps, which are published annually and provide an objective and independent assessment of performance, fees and costs, and the sustainability of member outcomes. We would also support mandating that trustees notify members in products which have failed the test.

Unlike for MySuper products (which receive contributions on behalf of members who have not made an active choice), **we do not believe *prima facie* that the failure of the performance test by a Choice investment option should result in the mandated closure of the option to new membership.** Rather, it may be appropriate for trustees to be required to justify to APRA why the continuation of an option which failed the test is in members' best financial interests.

In this context, it may be appropriate for performance test outcomes to be included in trustees' annual outcomes assessments under SPS 515 as well as included in SPS 530 to ensure that appropriate investment governance practices, trustee and regulatory oversight apply to products which fail the test. We believe these mechanisms provide appropriate and sufficient member protections whilst still acknowledging member choice and the nature of Choice options.

Retirement products

The Retirement Income Covenant (**the Covenant**) commenced on 1 July 2021, requiring trustees to have a strategy to assist their members to achieve and balance three prescribed objectives - *maximising their expected retirement income, managing expected*

*risks to the sustainability and stability of their expected retirement income, and having flexible access to expected funds during retirement*¹⁷.

Under the Covenant, trustees must consider their members' circumstances and are afforded flexibility to determine how they will assist their members based on the specific needs of their membership. This includes determining the appropriate balance of the three objectives in their strategy, recognising some cohorts may require greater focus on managing risks or flexible access to their savings over maximising the income provided in retirement. We understand this was a deliberate policy decision to allow trustees to align their retirement strategy to the specific needs of their members¹⁸.

Whilst it is important to ensure that good outcomes (including investment performance outcomes) are provided to members in retirement, we submit that the extension of the performance test to retirement products is likely to influence trustee determinations under the Covenant, leading to a greater priority given to *maximising expected retirement income* than may have otherwise applied.

Environmental, Social, and Governance (ESG) products

We acknowledge the Government has introduced legislation to utilise an alternative performance testing approach for faith-based superannuation funds and note this sets a precedent for circumstances where members have decided to invest in products due to their faith and not necessarily for reasons driven solely by investment performance.

We note ESG investment strategies are predominantly used for Choice investment options rather than for default MySuper products.

As previously outlined, we believe the MySuper performance test (including its consequences of failure) should remain unchanged, and that Choice investment options (including those which employ an ESG strategy) should be subject to an independent performance test based on investible passive benchmarks, with appropriate consequences applying to options which fail the test (which do not necessarily include mandating options being closed to new members).

To the extent that an appropriate hierarchy of consequences applies, we do not believe an alternative approach or custom benchmarks are necessary for ESG options.

If the consequences of a Choice performance test include mandating the closure of options, we submit that further consideration and granularity of benchmarks will be necessary.

¹⁷ *Superannuation Industry (Supervision) Act 1993*, s52(8A) & s52AA

¹⁸ Treasury, *Retirement Income Covenant Position Paper*, p.4 & p.7

YourSuper comparison tool

The YFYS Review consultation paper notes¹⁹ that the YourSuper comparison tool is intended to achieve two key objectives:

- First, to improve member engagement by providing members with simple, clear and trusted information to help them to compare and choose a well-performing MySuper product.
- Second, to encourage funds to compete by lowering fees and increasing returns for members

In the context of these objectives, Vanguard Australia supports the YourSuper comparison tool as an important measure to drive greater member engagement and facilitate comparison of MySuper performance and pricing.

We support the current approach to sort the results by fees from lowest to highest, placing underperforming products at the end of the list, and believe sorting by fees (rather than investment performance) is appropriate as fees are the primary forward-looking measure in the table. This also encourages trustees to reduce their fees to improve their position on the table, thereby delivering on the stated policy objective to encourage funds to compete by lowering fees.

Extension to Choice investment options

We note Treasury is seeking feedback on whether the YourSuper comparison tool should be extended to Choice investment options.

MySuper products are required to be developed in a homogenous manner and must be suitable for a wide range of consumers (due to their status as default products). This consistency between products allows for the simple comparison of product features currently employed in the YourSuper comparison tool.

However, with Choice options designed to meet a wide range of member needs, their structure, investment strategies and product features vary widely. As a result of this variety, simplified comparisons would be extremely difficult to present in an accurate and understandable table.

We submit that such a table would be extremely complex and may not provide an accurate or appropriate comparison of Choice investment options with other options of a similar nature.

¹⁹ Your Future Your Super Review, *Consultation Paper*, p.9

Furthermore, Choice investment options are not necessarily suitable for all consumers, with some options having been developed to meet specific member needs or circumstances. This is reflected in their often-restrictive target market determinations, which may limit investment into the product based on an individual's circumstances (including factors such as account balance, risk appetite, use of a financial adviser, or the sophistication of a member's investment knowledge). None of these factors nor target market determinations are currently included in the YourSuper comparison tool.

As such, we do not believe it would currently be appropriate to extend the YourSuper comparison tool to Choice investment options.

Stapling

The Productivity Commission found that linking the default system to the job or the employer – and not the member – led to unintended multiple accounts comprising one in three of all accounts, which directly cost members nearly \$1.9 billion a year in excess insurance premiums and \$690 million in excess administration fees²⁰.

The Productivity Commission estimated that this issue left a typical full-time worker 6 per cent (or \$51,000) worse off at retirement and was regressive, affecting younger and lower-income members the most²¹.

The Productivity Commission's findings and its recommendation for stapling were supported by the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission)*.

Vanguard Australia supports the recommendations of the Productivity Commission and Royal Commission for individuals to be stapled to a single default account.

We believe stapling is an important measure to prevent unintended multiple accounts and reduce incidences of account balance erosion due to unnecessary fees and insurance premiums from multiple accounts.

Whilst we acknowledge further work is necessary to improve Australians' engagement with superannuation, we do not believe changes to stapling are warranted or needed.

Given the significant findings of the Productivity Commission and the impacts of unintended multiple accounts on Australians' superannuation account balances (and ultimate retirement incomes), we do not support unwinding or watering down this consumer protection measure.

²⁰ Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness*, Inquiry Report, Finding 6.2

²¹ Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness*, Inquiry Report, p.16

Best financial interests duty

Vanguard supports the best financial interests duty and the increased focus this measure has brought to trustee governance and record-keeping, including the explicit consideration of members' best financial interests at all levels of decision making.

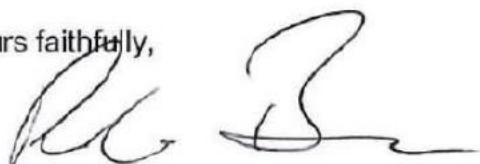
We believe trustees with sound governance practices should be able to demonstrate how their decisions have been made in members best financial interests. We have not identified any material issues for trustees to demonstrate their compliance with the best financial interests duty or record-keeping requirements.

As such Vanguard Australia supports the continuation of the best financial interests duty as currently drafted.

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We would be happy to discuss any area of this submission in further detail.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Robin Bowerman', written over the typed name.

Robin Bowerman
Head of Corporate Affairs – Vanguard Australia