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Review of Your Future, Your Super Measures

Introduction

The Australian Financial Markets Association (AFMA) welcomes the review of Your Future, Your Super measures to consider whether there have been any unintended consequences or implementation issues arising. AFMA represents the interests of over 120 market participants in Australia's wholesale banking and financial markets. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

AFMA's Inflation Products Committee is comprised of the majority of the major market participants in the Australian inflation linked bond market and inflation swap market. AFMA and members of the Inflation Products Committee are concerned about an unintended consequence of Your Future, Your Super (YFYS) measures that has impaired trading in AUD denominated inflation linked bonds. The legislation has been a contributing factor to both asset allocation out of inflation linked products and lower new allocations.

The Treasury Laws Amendment (Your Future, Your Super) Act 2021 has four key elements to improve the superannuation system. The Performance Test is one of these elements and was designed to protect superannuation fund members from underperformance by holding trustees accountable for the investment performance they deliver to members. The test assesses a product's net investment returns against an objective benchmark portfolio tailored to its investment strategy and assesses its administration fees against its peers.

The key issue is that the objective benchmark for the Performance Test to measure fixed income products in Australia does not include inflation linked bonds. The Bloomberg Ausbond Composite 0+ index excludes inflation linked bonds which means that any existing or future investment in inflation linked bonds is off index and subject to tracking error.

Question 1: Does the measurement of actual return using strategic asset allocation affect risk-taking behaviour by superannuation trustees?

Yes, the measurement of actual return against a benchmark index using strategic asset allocation has inadvertently incentivised increased risk-taking behaviour by disincentivising a lower risk class of products for superannuation funds.

Inflation linked bonds are an important strata of Australia's fixed income markets. Long term, fixed income products bought by superannuation trustees are impacted by inflation through the dampening effect on investment returns if there is no offset for the risk of inflation.

Inflation linked bonds are a unique asset class because when held to maturity they offer a nearly perfect hedge against inflation while having a low correlation to other risk assets. Superannuation fund managers choose to purchase inflation linked bonds for their portfolios because they provide protection for both income and capital against inflation, delivering better risk adjusted returns for members in certain scenarios.

The new performance measures affect asset allocation decisions for inflation linked bonds because inflation linked bonds are not included in the benchmark index. Superannuation trustees are increasing inflation risk for their portfolios and for their members by reducing existing and future allocations to inflation linked bonds in order to better track the benchmark index.

The Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC) implemented The Retirement Income Covenant effective from 1 July 2022. Registrable Superannuation Entity (RSE) licensees are required to formulate a retirement income strategy and publish a summary of the strategy on the superannuation entity's website. The Explanatory Memorandum for the covenant set out some considerations that a prudent RSE licensee would consider in order to develop an effective retirement income strategy to assist members in or approaching retirement. This included decisions on how to define and to help members to manage specific risks including inflation risks. Having an effective and liquid inflation bond and swap market is critical to this management of these inflation risks.

Question 2: Does the current set of indices used to calculate benchmark returns unintentionally distort investment decisions or reduce choice for members? If so, is there a way to adjust the benchmark indices while maintaining a clear and objective performance test?

Yes, the current choice of the benchmark index to use in the performance test to measure fixed income products in Australia is adversely impacting investment decisions because superannuation trustees and fund managers are reluctant to allocate a portion of their portfolio to products that will provide a suitable hedge and protection against inflation.

The YFYS performance test index for the measurement of performance in fixed income products is the Bloomberg Ausbond Composite 0+ which does not include inflation linked products. The YFYS legislation has significantly impaired demand for inflation linked bonds due to the sole use of the Composite 0+ benchmark for all AUD fixed income products. For superannuation trustees, this implies that holding inflation linked bonds is "off-index" and subject to tracking error against the benchmark index.

There are two simple solutions to remedy this situation and ensure that inflation linked products are included in a benchmark index for performance measurement:

1. Add the Bloomberg AusBond Infl Gov 0+ Index to the list of approved indices, or,

2. Replace the Bloomberg AusBond Composite 0+ Index with the Bloomberg AusBond Master 0+ Index

Question 4: What are the longer-term impacts of the performance test on market dynamics and composition? How will these factors impact on long-term member outcomes?

The reduction in allocations by superannuation trustees has weighed on inflation bond and inflation swap valuations, lowered new investment into these market products, and is hampering the efficient functioning of the inflation linked market by disrupting price discovery and market liquidity. There are significant longer-term impacts on market dynamics and composition from the reduction in allocations to inflation inked bonds due to the performance test.

It is important to have a well-functioning inflation products market. More than thirty central banks use inflation targeting as a central tenet of their monetary policy including the Reserve Bank of Australia (RBA). Assessing the current and expected rate of inflation against the inflation target helps the RBA in making monetary policy decisions.

Inflation expectations are the rate at which participants in the economy expect prices to rise in the future. Inflation expectations matter because actual inflation depends, in part, on what market participants expect it to be. One widely used metric of market-based inflation expectations is the Break-Even Inflation rate (BEI) which is the difference between the yield of a nominal bond and an inflation linked bond of the same maturity. The BEI is the main market-based measure for term inflation used by central banks globally, including the RBA.

A lack of liquidity and price transparency caused by reduced demand for inflation linked bonds will distort the market measure of inflation and the BEI would be arguably lower than it should be due to the impact of the YFYS performance measurement. This provides the wrong market-based inflation expectations signal to the RBA as part of their monetary policy deliberations.

The BEI is also important for broader fixed income markets because inflation expectations and expectations for monetary policy are drivers of trading activity in short term and long term interest rate markets. Inflation is a key risk for insurance markets, defined benefit superannuation and the real economy. Having an active and healthy inflation products market is important for risk mitigation and efficient pricing of insurance and defined benefit liabilities. Additionally, interest rate traders determine their hedging requirements and trading strategies by forecasting the likely shape of the yield curve based on their expectations for how monetary policy and official interest rates will evolve over time.

A reduction in demand for inflation linked bonds will could adversely affect Government funding. The Australian Office of Financial Management (AOFM) issues Treasury Indexed Bonds (TIBs) with the purpose of increasing overall Australian Government Security (AGS) investor diversity. A reduction in demand for TIBs reduces the diversity of investors and sources of funding for the Australian Government.

The inclusion of inflation linked bonds in investors' portfolios times provides diversification and protection during periods of economic uncertainty. Inflation linked bonds are one of the few investments which perform well in a lower growth inflationary economic environment, reducing the combined risk of high inflation and low growth and outperforming other fixed income products at a time when investors need protection the most.

Investors need a healthy, functioning inflation bond market to get real return protection. Superannuation trustees and investors can achieve this by buying inflation linked bonds to provide a total return of the fixed real return plus the inflation rate to maturity. This is a key part of the investment mix for pre-retirement and retirement portfolios.

Inflation linked bonds provide diversification for Australians operating self-managed superannuation funds who are either approaching retirement or are already retired. Those approaching retirement and still in the accumulation phase can protect themselves from inflation by investing in capital indexed bonds. Those SMSF investors already in retirement, without the protection of a wage and in the drawdown phase, can invest in indexed annuity bonds, helping to return capital and to meet minimum withdrawal requirements as investors age.

Conclusion

The purpose of the YFYS review is to assess any unintended consequences and implementation issues of the YFYS legislation. The performance test to measure fixed income products has led to unintended consequences for Australia's Inflation Products markets. The Bloomberg Ausbond Composite 0+ index used as the performance measurement benchmark for fixed income portfolios excludes inflation linked bonds. Any superannuation trustee that includes inflation linked bonds in their portfolio is incentivised to be underinvested in inflation linked bonds due to the consequences of underperforming the benchmark index.

AFMA recommends that Treasury adopt a better benchmark index that includes inflation linked bonds to measure the performance of fixed income portfolios; specifically, either:

1. Add the Bloomberg AusBond Infl Gov 0+ Index to the list of approved indices, or,
2. Replace the Bloomberg AusBond Composite 0+ Index with the Bloomberg AusBond Master 0+ Index

Having a well-functioning inflation products market will help Australia remain a relevant financial markets centre.

Yours sincerely,

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