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ASFI Submission to the Annual Superannuation Performance Test Consultation Paper

About ASFI

ASFI is a not-for-profit organisation working to align the Australian financial system with a sustainable, resilient, and inclusive Australia. Our members are 44 of Australia's leading financial institutions – including major banks, superannuation funds, insurers, asset managers, and financial services firms. ASFI members collectively hold over AU$22 trillion in assets under management and are committed to allocating capital in a way that creates positive social and environmental outcomes.

Executive Summary

ASFI welcomes the opportunity to provide feedback in relation to the Australian Government's consultation paper on design options for the Your Future Your Super (YFYS) Annual Superannuation Performance Test. The YFYS performance test was introduced for the purpose of protecting Australians' retirement savings by holding trustees to account for the investment performance they deliver and the fees they charge.

While the test may have been at least partially successful in identifying under-performing products and encouraging industry consolidation, there have been unintended consequences. As identified in the consultation paper, these include that it encourages short-term decision making and benchmark hugging; constrains investment flexibility; and reduces member choice, product diversification and active management.

An important consequence is that the test is significantly constraining the ability of super funds to adopt green or sustainable finance investment strategies at scale. This is at odds with Australia's national transition goals and inhibits appropriate management of systemic climate and other sustainability risks. It may limit super funds' ability to invest in accordance with member preferences, and potentially to invest in accordance with members' best financial interests over the long term. This is suboptimal for members. Increasingly, there may also be a tension between satisfying the current YFYS performance test and complying with the emerging sustainable finance policy framework which encourages super funds to develop and disclose climate transition plans, and government recognition of the importance of private capital to support Australia's climate transition.

While there is no easy solution to the issues identified above, ASFI considers that the Government can and should improve the test through implementing reforms.

To support funds to adopt sustainable investment strategies, ASFI recommends the following:

- Additional sustainability-specific indices should be identified or developed for inclusion as optional benchmarks for funds that adopt credible sustainable investment strategies. ASFI recommends the Government commit to undertaking further work on this, and consider appointing a credible, independent third-party entity or expert group to lead this work. The Government should also consider options to address the increasing costs of index licensing fees which are negatively impacting member outcomes.

- Continue to monitor and assess the unintended consequences of the performance test over time. Depending on the outcome of these regular assessments, Government could, over time, consider moving towards a qualitative approach to regulating super fund performance that empowers APRA to make forward-looking assessments of fund capability and risk management.

1. Impact of the YFYS performance test on sustainable investment

There is significant anecdotal evidence that the YFYS test is constraining sustainable investment at scale, including investment in renewable energy projects and other activities where capital is critically needed for the net zero transition in Australia and in other markets.[1] ASFI members who are asset owners or asset managers consistently raise YFYS as a key barrier to allocating more capital to green activities.

Quantitative analysis supports these claims. In November 2022, the Conexus Institute and FTSE Russell, supported by ASFI and the Responsible Investment Association of Australasia, published a study estimating the performance test tracking error resulting from implementation of three different investment strategies with sustainability and/or carbon transition objectives.[2] The study found that some of the mainstream implementations of sustainable strategies (for example, standard exclusions for fossil fuel industries) create unsustainably high levels of performance test tracking error, increasing the risk of YFYS test failure. It also finds that dedicated unlisted investments in 'green' opportunities such as private equity and infrastructure (e.g., renewable energy projects) are likely to incur a sizable incremental tracking error

The Conexus Institute / FTSE Russell analysis also showed that even portfolios that seek to align capital allocation with a moderate decarbonisation trajectory (specifically, in line with the Australian Government's target to reduce emissions by 43% by 2030 and reach net zero by 2050) would risk an unacceptable level of tracking error. This means the YFYS performance test presents an issue not only for choice products labelled or marketed as 'green' or 'sustainable', but for default products seeking to maintain a moderately conservative (i.e., gradual) decarbonisation trajectory. Funds that aim to decarbonise in line with Paris Agreement trajectories (which would imply steeper emissions cuts than the Government's 43% target) face an even greater challenge.

2. Why this matters

The impact of the performance test on sustainable investment matters for three reasons:

1. **It constrains super funds from investing consistent with member preferences**. Increasingly, Australians want to align their superannuation holdings with their values, including as they relate to climate change and sustainability.[3] Super funds seeking to respond to this market demand are unable to do so without risking tracking error and ultimately performance test failure.
2. **It discourages diversification and is fundamentally at odds with managing climate and sustainability risks and pursuing climate-related opportunities as the economy transitions.** YFYS performance test benchmarks encourage funds to make similar investments to each other which exposes the sector to systemic risk. This includes carbon transition risk, particularly where benchmarks (such as the ASX 200 index) have relatively high carbon exposure. Rather than enabling super funds to act as responsible custodians of Australians' wealth, that take into account both the longer-term performance of their investments and the type of world into which members will retire, super investment is likely to lag behind the broader economy in its ability to transition. Conversely, analysis by Mandala Partners estimates that *removal* of regulatory barriers to green investment would have significant positive impacts – resulting in $170 billion GDP increase and 620,000 new green jobs over 10 years.[4]

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[1] See media reporting, eg 'Labor accused of risking super protections in test overhaul' Australian Financial Review, 7 December 2023, https://www.afr.com/politics/federal/labor-accused-of-risking-super-protections-in-test-overhaul-20231206-p5epoo accessed on 3 April 2024.

[2] David Bell and Trista Rose, Your Future Your Super Performance Test: Constraint on ESG, Sustainability, and Carbon Transition Activities, Conexus Institute.

[3] Responsible Investment Association Australasia, 'From Values to Riches 2024: Charting consumer demand for responsible investing in Australia' https://responsibleinvestment.org/wp-content/uploads/2024/03/From-Values-to-Riches-2024_RIAA.pdf

[4] Mandala (2023). 'Superannuation and Climate Change: Better Returns for a Better Climate", https://mandalapartners.com/uploads/Future-Super-Report.pdf

3. **It may be at odds with members' best financial interests particularly over the longer term.** In the short term, there are instances where 'benchmark hugging' may result in higher returns – for example, fossil energy stocks performed unusually well in 2022 due to factors such as the Ukraine war. However, the Reserve Bank of Australia has found that medium and long-term performance of 'ethical' funds is on par with other funds.[5] Going forward, higher exposure to carbon transition and other risks may negatively impact performance. This is bad for members' retirements savings. It also means complying with the YFYS framework could result in breaches of Trustees' fiduciary duties – a difficult position for super funds. Similarly, there is a growing tension between YFYS and the Government's sustainable finance agenda. The latter encourages super funds to demonstrate alignment of their portfolios and investment strategies with sustainability goals through climate-related disclosures. But doing so puts them at risk of failing to meet the YFYS test – with potentially existential consequences.

3. What is the fix? Options for reform

There is no easy solution to the challenges posed by the YFYS performance test while maintaining a quantitative 'bright line' test. We note that the mandatory application of a quantitative performance test is unique to Australia. Pension fund regulation in other parts of the world typically adopts a more qualitative approach. Over time, and as the Australian superannuation industry continues to undergo consolidation, and based on regular assessments of the intended and unintended impacts of the test, the Government should consider shifting away from a performance test to a qualitative approach. This would allow APRA to assess a more diverse range of factors that impact fund performance on a forward-looking basis such as: capabilities of the fund with regards to governance, teams, systems and processes; actions taken by the fund to improve capabilities where any concerns have been identified; performance of the fund beyond implementation performance.

For now, the Government has committed to retaining a quantitative performance test. In this context, the Consultation Paper does a good job of identifying potential reform options. ASFI's comments on the options and the implications of each for sustainable investment strategies are set out below.

- <u>Option 1 – Status quo</u>

  As outlined above, the current approach is inhibiting sustainable investment and presents significant issues for both member outcomes and super funds' ability to perform their duties. ASFI does not support retention of the test in its current form but recommends inclusion of additional benchmark indices that allow for and reflect carbon transition and sustainable investment strategies (see Part 4, below).

- <u>Option 2 – Alternative single metric</u>

  Any single metric approach will by definition focus on a single dimension of fund performance and encourages funds to be managed to maximise performance according to that particular metric. ASFI considers that this is unlikely to result in optimal outcomes for members, particularly from a sustainability perspective.

- <u>Option 3 – Multi-metric framework</u>

  A multi-metric framework, if it adequately incorporates sustainability considerations, could also drive a more balanced consideration of performance and members' best financial interest. This allows for a more multi-faceted assessment of fund performance and reduces the ability of and incentive for funds to actively manage to meet any single metric rather than to achieve overall best financial interests. If one of the multi-metric options is preferred, this should ensure metrics are chosen and structured to avoid unintended consequences that would reduce the ability of funds to invest in sustainable investment strategies or climate transition opportunities.

- <u>Option 4 – Alternative framework</u>

[5] Armour, C., Hunt, D. & Lwin, J., 2023. Green and Sustainable Finance in Australia. *Reserve Bank of Australia Bulletin – September 2023.* https://www.rba.gov.au/publications/ bulletin/2023/sep/green-and-sustainable-finance-in-australia. html?&utm_source=rbanews&utm_medium=email&utm_ campaign=bulletin-2023-sep&utm_content=sustainable-finance

As noted above, it is open to the Government to adopt a qualitative assessment where APRA assesses a range of characteristics that together indicate the capability of that fund to invest in accordance with members' best financial interests. This type of assessment could be introduced and used in conjunction with a quantitative test to assess fund performance.

4. Carbon transition or sustainable benchmark indices

Use of benchmarks

If carbon transition or sustainable indices are included in the performance test framework, ASFI considers the following should apply:

- Use of these indices should be optional for funds that are pursuing credible transition or sustainable investment strategies. Once developed, we expect the Government's product labelling framework will help ensure funds and products are true to label; and
- To support transparency and prevent index shopping, funds should be required to elect in advance if they intend to use these indices.

Choice of benchmarks

ASFI recognises that it is challenging to identify suitable carbon transition or sustainable benchmark indices. Since funds adopt a wide range of sustainable investment approaches, it will be difficult to select an index or collection of indices that reflect all strategies. For some asset classes, appropriate sustainability indices may not exist and may need to be developed.

ASFI recommends the Government commit to undertaking further work on this, and consider appointing a credible, independent third-party entity or an expert group to advise on the development and/or selection of appropriate low carbon / sustainable benchmark indices.

Costs of index licensing for super funds

The use of benchmark indices in the YFYS Performance Test requires funds to access specific benchmark data to track the performance of products and portfolios and manage tracking error. ASFI understands that index licensing fees have increased significantly since the introduction of the YFYS Performance Test. Higher fees are passed on to members, reducing the returns available to members for their retirement. Complex and opaque licensing terms make it difficult to compare prices and negotiate with providers. Globally, lack of competition and high barriers to entry in the market for index providers is likely resulting in high costs and other adverse consumer outcomes.[6]

ASFI recommends the Government consider options to address the increasing costs of index licensing fees on member outcomes. Options could include:

- Review of the existing licensing regime for financial benchmark administrators, including to require greater price transparency and enable licensees to switch providers;
- The Government identifying and substituting equivalent, cheaper indices in the performance test regulations. Where these do not exist, the Government could work with industry and/or a credible third party to create generic indices that meet the test requirements and achieve significant savings for members.

[6] Market Study MS23/1.5, Financial Conduct Authority, Wholesale Data Market Study – Report February 2024, https://www.fca.org.uk/publication/market-studies/ms23-1-5.pdf ; Yu An, Matteo Benetton and Yang Song, 2023, "Index Providers: Whales Behind the Scenes of ETFs", Harvard Law School Forum on Corporate Governance, https://corpgov.law.harvard.edu/2023/08/08/index-providers-whales-behind-the-scenes-of-etfs/ .