

Submission: Superannuation Performance Test Treatment of Faith-based Products

16 August 2022

Overview

The Responsible Investment Association Australasia (RIAA) thanks The Australian Government for the opportunity to comment on the proposed changes to the performance test treatment of faith-based superannuation products in Treasury Laws Amendment (Measures for a later sitting) Bill 2022: Faith-based products (the draft Bill).

RIAA supports the Government's intention to undertake a broader review of the superannuation performance test. We will provide consolidated feedback via that review process with regard to the issues the current performance test presents for products which factor environmental, social and governance (ESG) considerations into the investment strategy.

Faith-based superannuation products are a subset of ESG superannuation products. Products which consider ESG issues operate in a smaller investment universe, due to the importance of non-financial metrics in investment strategies. Whether faith-based or not, the screening in place necessarily means some products' alignment to the performance test benchmark may not be strong. However, the performance of ESG against a benchmark will fluctuate over time, with some overperformance and underperformance depending on market conditions.

Australians are increasingly keen to align investments with their values, for example, aligned with their faith-based beliefs or views on animal rights or climate change.¹ It is important that regulations do not thwart this real and growing demand from consumers.

While RIAA welcomes the acknowledgement of the complexities of the performance test for ESG-informed products, we have concerns with the rationale for carving out faith-based products only from the performance test, and the current proposal for how to do so. RIAA's views and recommendations are outlined below.

Recommendations

1. That faith-based products be included in a broader review of the superannuation performance test, to ensure:
 - a. the treatment of ESG-informed superannuation funds and products is consistent, and
 - b. the performance test does not impact investors' ability to invest their superannuation in line with their values.
2. If the proposed regime for faith-based products goes ahead, that the legislation specify:
 - a. a detailed definition of 'faith-based' products,
 - b. specific things that APRA must consider when deciding whether to approve a 'faith-based product',
 - c. specific requirements that must be placed on approved products, and
 - d. specific things that must be included in any alternative test for a particular faith-based product.

¹ See Responsible Investment Association Australasia, [From Values to Riches 2022: Charting consumer demand for responsible investing in Australia](#), 2022.

Consistent treatment for ESG products

While ESG and faith-based investment approaches can return strong financial returns in line with members' values, the performance test has created challenges for superannuation funds that incorporate ESG considerations into their investment approaches. In particular, the current volatility of some markets and the longer-term outlook of superannuation products which factor in ESG issues are key considerations when looking at performance test outcomes for superannuation products.

Variations in short-term product performance under the current test may be due to a range of non-financial factors in the investment approach, such as ethical, faith-based, environmental, social/human rights or corporate governance considerations, and should be considered in light of the time horizon. There is no clear rationale for separating faith-based approaches from broader ESG approaches, when many of the drivers and outcomes can be common to each.

Faith-based investing has a long history and has played an important role in the development of the responsible investment sector in Australia and overseas. Faith-based funds have been focused on their own investment objectives and the unique needs of members and investors with aligned ethical and ESG mindset. The investment objectives result in differences in risk-tolerance level, investment strategies and underlying portfolio design. As one RIAA member of long standing and deep experience has stated, 'Values and faith-based investors demand the right to allow their deepest held values to shape their financial decisions and refuse to sacrifice at the altar of maximum return with no regard for how that is earned.'

Given the history of faith-based investment, there is healthy diversity among faith-based funds and products. Faith-based investment approaches can reflect more conservative or more liberal views in their screening of particular industries or activities. For example, a Christian product, an Islamic product and a 'socially responsible' non faith-based product could have very similar holdings, despite their different screening processes and investment strategies. Research has found that, depending on the screening methodology applied, between 20% to 43% of ASX 200 companies were compliant with Shariah-based screening in 2019.² It is therefore unclear why faith-based approaches would be distinguished from broader ESG-informed approaches, given the similarities between products.

Lack of suitable indices

Implementing an alternative test, as some have proposed, would result in a move away from a standard benchmark, and towards a set of tailored tests which are informed by each product's investment strategy.

If the rationale and structure of the performance test change, there may not be suitable indices to form appropriate alternative tests for all faith-based products. This significantly challenges the viability of the proposal. For example, it is acknowledged that there is no appropriate index for Shariah-based investment in Australia. The MSCI USA Islamic Index in the United States or the MSCI ACWI Islamic index could be a benchmark for equities in that market, but it is inappropriate for superannuation products which include Australian equities and other holdings.

Some approaches that may technically produce an individual product test may include:

- **Alternative tests based on asset classes:** For most asset classes, the standard indices would still be applicable. However, for asset class where the product's investment strategy varies significantly because a faith-based approach excludes a number of investments, 'ex-screening' indices could be determined. For example, for Australian equities this could be the S&P/ASX 300 reweighted to remove any investments that were excluded for that product.
- **Tracking error leeway:** A percentage of discount/leeway could apply to the standard performance test.

However, there would remain the issue of enabling products to effectively 'pass' the test with a lower score on the basis of the current proposal, or to pass a test which is more complex than the current benchmark.

² El Saleh, A. I., & Jurdi, D. J. (2021). 'Stock performance under alternative Shariah screening methods: Evidence from Australia'. *Accounting & Finance*, 61(3), 4339-4388.

Lack of detail in the draft Bill

While RIAA welcomes the acknowledgement of the issues with the performance test for ESG products, we note that the draft Bill:

- lacks a detailed definition of what constitutes a 'faith-based product',
- gives APRA broad discretion in approving what is considered a 'faith-based product',
- gives APRA broad discretion to apply an alternative test with the index/indices identified in a fund's application or alternatives, and
- gives APRA broad discretion to apply any requirements where it approves an alternative test for a faith-based product.

The proposal in its current form is therefore unlikely to ensure any consistent underlying principles in APRA's administration of the faith-based product regime and performance test. This proposal, especially if extrapolated to ESG-based or other products more broadly, could significantly weaken the consumer protection value of a standard benchmark for superannuation products. We do not support the approach of removing products from the standard performance test based on unclear criteria. This has the potential to muddy the rationale for different treatment for certain products, and will make the performance of products less clear and comparable.

Recommendations

The proposed regime would be strengthened by including:

- A more detailed definition of 'faith-based product', to ensure consistent treatment of applicants. For example, this could draw on legal definitions of 'religion' and/or the Australian Bureau of Statistics' Australian Standard Classification of Religious Groups, which is currently under review.³
- Specific things that APRA must consider when deciding whether to approve a 'faith-based product', for example:
 - the product documents, processes and governance, including whether these are adequate to ensure the marketing materials will include the required disclosures, and
 - whether a suitable index is available, in order to ensure any alternative test is appropriate for the product.
- Specific requirements APRA must place on approved products, for example, a requirement to report to APRA any changes to the investment strategy and/or marketing materials.
- Specific things that APRA must consider when formulating the alternative test for a particular faith-based product, for example, whether the test is appropriate for the portfolio holdings of the product.

About RIAA and our members

RIAA champions responsible investing and a sustainable financial system in New Zealand and Australia and is dedicated to ensuring capital is aligned with achieving a healthy society, environment, and economy.

With approximately 500 members managing more than US\$29 trillion in assets globally, RIAA is the largest and most active network of people and organisations engaged in responsible, ethical and impact investing across New Zealand and Australia. RIAA's membership includes superannuation funds, KiwiSaver default providers, fund managers, banks, consultants, researchers, brokers, property managers, community trusts, foundations, faith-based groups, financial advisers, financial advisory groups, and others involved in the finance industry, across the full value chain of institutional to retail investors.

³ Australian Bureau of Statistics, [Australian Standard Classification of Religious Groups](#), 18 July 2016 (under review).