Submission

Exposure Draft: Superannuation Industry (Supervision) Amendment (Your Future, Your Super— Addressing Underperformance in Superannuation) Regulations 2023

3 May 2023

Overview

The Responsible Investment Association Australasia (RIAA) thanks Treasury for the opportunity to comment on the *Exposure Draft: Superannuation Industry (Supervision) Amendment (Your Future, Your Super— Addressing Underperformance in Superannuation) Regulations 2023* (Exposure Draft Regulations).

RIAA welcomes the limited changes to the Your Future Your Super (FYYS) performance test for superannuation products proposed in the Exposure Draft Regulations. We note that the Assistant Treasurer and Minister for Financial Services stated that these changes are intended to 'address several unintended consequences of the test identified in the review, while maintaining the test's integrity'.

In RIAA's view, the Exposure Draft Regulations will improve some aspects of the performance test. The proposed changes could better accommodate the diversity of investment approaches among choice products and improve the accuracy of benchmarking. This includes 'values-based' products which apply responsible investment approaches (such as ESG integration, negative and positive screening, and stewardship), and which take a longer-term view of sustainable financial returns.

However, the proposals are unlikely to address some of the core challenges for these types of funds. We therefore welcome the Minister's announcement that the Government 'will give further consideration to other changes that may be necessary to improve fund performance'.

Our views on key aspects of the Exposure Draft Regulations and ongoing challenges for values-based products under the performance test are detailed below.

Exposure Draft Regulations

Ten-year 'lookback' period

RIAA broadly agrees with Treasury's assessment that extending the lookback period from eight to ten years could 'sharpen the incentive of trustees to focus on long-term decision making and aligns with broader industry disclosures' (Explanatory Statement, page 2). We consider ten years to be a minimum timeframe, considering the impact of relatively short-term fluctuations to markets on the tracking error of funds which apply responsible investment approaches (for example, recent spikes in some resource prices). We note that some funds target their performance over longer timeframes (for example, 12 years) and that longer-term metrics can iron out short-term problems with tracking error.

More granular asset classes

RIAA broadly supports the proposed inclusion of more granular indices, which could enhance the accuracy of the test and reduce disincentives to invest in certain classes of assets.

RIAA is aware of some practical challenges that these indices may present for funds, including:

- **Potential impact on asset allocation:** given the relatively short lead time for the proposed changes, funds may have already made strategic asset allocations in line with the previous benchmark, and
- **Cost to funds**: funds will be required to pay for the additional indices.

We would welcome further work by Treasury to identify alternative or additional indices and metrics which would better reflect the diversity of investment approaches of values-based products.

In particular, one solution would be to allow for Paris-Aligned benchmarks (PABs) be applied to any asset class benchmark for funds that have in place net-zero commitments. We understand that this approach is being applied in the European Union. While PABs may not be immediately available in the Australian market, index providers could to rapidly establish such benchmarks across many asset classes, if this was to become a viable option.

Revised member notification letter

RIAA does not have specific comments on the proposed changes to the letter required to be sent to members when a fund fails the performance test. We note as a general point that well-crafted consumer communications are an important part of transparent, targeted communications. However, disclosure-based consumer protections can be less effective than expected in influencing consumer behaviours (see for example ASIC, REP 632 Disclosure: Why it shouldn't be the default, October 2019).

Impacts of the performance test

The performance test raises a number of challenges for the investment strategies and performance of some superannuation funds which offer values-based products.

RIAA encourages Treasury to further examine and address the following challenges as a priority, as they may be amplified with the introduction of the performance test for choice funds. We would encourage future reform that ensures:

- superannuation funds can meet growing consumer demand for values-based products,
- the performance test benchmark, particular the underlying indices, is not deterring funds from directing capital to assets which will meet global commitments such as the Paris Agreement goals and Sustainable Development Goals, and
- the performance test is not misaligned with other policy objectives and regulators' expectations.

Meeting consumer demand for values-based products

It is unclear whether the long-term intent of the YFYS performance test is to restrict products for which there may be member demand, but which may not pass the performance test as it is currently formulated.

Superannuation fund members increasingly expect their money to be invested in line with their own values, in addition to returning strong financial returns.

RIAA's study, From Values to Riches 2022: Charting consumer demand for responsible investing in Australia found:

- **High expectations that funds will invest responsibly:** 83% of Australians expect their bank account and their super to be invested responsibly and ethically. For over 80% of the population, this means that their investments deliver a positive impact to the world.

- **Belief that responsible investment performs better:** 64% of Australians agree that responsible and ethical superannuation funds and investments perform better in the long term.
- **Demand for action on climate change:** The vast majority of Australians believe it is important their superannuation fund or bank commits to reducing GHG emissions (84%) and sets targets for emissions reductions (83%). 81% want to see them pledge to achieve net zero by 2050.
- **Interest in investing more to make a difference:** 61% of Australians would be motivated to try to save and invest more money if they knew their savings and investments made a positive difference in the world.

There are significant differences between the views of older and younger Australians. For example, different generations responded very differently to the question of whether they would be more motivated to try to save more if their savings and investments made a positive difference in the world:

- Gen Z: 83%
- Millennials: 75%
- Gen X: 57%
- Baby Boomers: 39%

We note that some Gen Z superannuation fund members today will retire in the 2070s, and that this cohort and time horizon should be considered significant when viewing the systemic risks of poor longer-term performance of unsustainable assets.

Impact on investment strategy

The current formulation of the test can feasibly influence funds to take approaches that are geared towards meeting the benchmark (including the specific timeline and underlying indices), potentially at the expense of other objectives such as meeting consumer demand for product features, or delivering longer-term returns. This could include, for example, reluctance to align funds to PABs or to invest in types of assets which will create a risk of an unacceptably high tracking error.

In our view, further Treasury work should consider more targeted measures to ensure the test is not unintentionally shifting funds towards ‘benchmark hugging’. This may include the incorporation of specific ESG or risk-adjusted metrics into the performance test.

RIAA would welcome a close re-examination of what underlies the performance test, and whether it reflects the direction of responsible investment approaches now and into the future.

Misalignment with other policy and regulatory requirements

The current performance test formulation appears to be misaligned with some other aspects of Government policy, for example:

- The Government is seeking to partner with superannuation funds on affordable housing initiatives, however this could entail funds investing in an asset class which significantly worsens a fund’s tracking error.
- The regulators expect funds to factor climate change into their risk management. For example, APRA’s CPG 229 Climate Change Financial Risks requires financial institutions to manage climate risks and opportunities and ASIC has publicly stated that company directors should be managing climate risks. However, investment approaches that seek to achieve this can impact a fund’s tracking error, for example, by screening out a company or sector which has a significant impact on the short to medium-term performances of the ASX 300.

A coherent long-term policy and regulatory environment in Australia is critical to support robust responsible investment approaches, and to attract global capital.