25 April 2024

Superannuation Efficiency and Performance Unit
Retirement, Advice and Investment Division
The Treasury
Langton Crescent
PARKES ACT 2600

Submitted via email to: YFYS@treasury.gov.au

RE: Superannuation Performance Test Review 2024

To the Treasury

BlackRock Investment Management (Australia) Limited (**BlackRock**) appreciates the opportunity to comment on the further review of the *Superannuation Performance Test*.

BlackRock is an Australian public company and licensed provider of financial services. In Australia we invest approx. AUD $180bn, predominantly on behalf of Australian wealth and wholesale investors. We partner with the Federal Government and most state governments and large superannuation funds to provide specialist investment management, indexed, factor and active investment portfolios, and our bespoke investment technology, Aladdin.

BlackRock is not a superannuation trustee. We provide specialised portfolio construction support to trustees to enable them to deliver strong, risk adjusted returns to their members. We are providing our view on the merits or otherwise of the performance test options, without reference to any superannuation product.

We have assessed the detailed consultation paper and provide some observations below. We have not taken an approach of answering specific consultation questions but have instead provided our broader views on superannuation performance testing, considering our position as a fiduciary and not an RSE licensee.

Key considerations

The test, or a version of it, was originally recommended by the Productivity Commission (PC) to address a tail of underperformance in the industry. The test has, to a substantial degree, achieved this with test failures leading to consolidation and product closures. If the test continuously creates a new tail that is then eliminated, this will fundamentally change the composition of the industry and may lead to undesirable concentration that does not serve members' interests. Equally, if the test embeds only certain benchmarks and portfolios are substantially or partly constructed around these, this may lead to members missing out on investment opportunities. Both outcomes would be misaligned with the first principle for the test in the consultation paper – improve member outcomes.

We provide further detail below but note that several of the options proposed in the consultation paper would perpetually create a tail of underperformers because the test is an objective instrument with a pass/fail result. All proposed metrics have pros and cons, many of which would not be foreseen before any changes to the test are implemented. The proposed options for changing the test still present substantial risk of false negatives and unintended consequences.

In undertaking a new review of the performance test and considering further changes, we suggest that the critical question is, what is the key outcome sought to be achieved and what is the simplest and easiest way to achieve that outcome. If the key outcome is to facilitate investment in emerging/unrepresented asset classes for the long-term financial benefit of members, then we submit that the minimum/least disruptive changes to the test to achieve this are the targeted modifications set out in this submission.

More extensive changes that fundamentally alter the testing approach will involve additional cost to implement and will likely create new uncertainty and instability in the system. Changing the rules again on a retrospective basis is likely to result in unintended consequences that cannot be foreseen prior to implementation. This would not be the preferred approach. The simplest changes to achieve the key desired outcome would be preferred, to minimise the risk that new complexity will lead to undesirable outcomes.

We would also suggest that changes to the test be considered in the context of the current and likely future state of the industry, not the state of the industry that existed when the PC made its recommendations, or when performance testing was originally legislated. Times have changed, the industry and products have changed, investment opportunities are constantly changing, and the outcomes for members have changed. New policy should respond to the current environment and should aim to deliver long-term, sustainable outcomes for members, and be robust for the future.

In line with the above, we recommend retaining the current test with four key changes:

1. The threshold for failing the test should be increased from 50 to 100 bps;
2. Where a product fails the test, APRA should assess whether the risk adjusted real returns achieved for members over the period, and likely to be achieved into the future, are reasonable, and adjust any consequences accordingly;
3. Additional benchmarks, including for sustainable investments; and
4. Blended (public/private) finance funds as a new benchmark.

Modification 1 - Increase the threshold

One straightforward way to provide more flexibility is to increase the test threshold from 50 to 100 bps. This alone would provide substantially more scope to deviate from the set benchmarks and may facilitate greater investment in emerging and alternate asset classes. A higher historical threshold would also reduce the incidence of adverse risk-taking and risk-aversion behaviour in future asset allocation decisions, particularly as the test is continuing to roll out to new product categories. It would further provide some additional buffer to account for the simplistic tax assumptions used in the benchmark methodology which adds an additional source of uncontrollable performance tracking error relative to the benchmark.

Modification 2 - APRA discretion given the serious potential consequences of failure

We have previously submitted that the test should be broadened to evaluate a product's total returns, adjusted for the risk in the portfolio, as well as the effectiveness of implementing the asset allocation. In our view, this would ensure the best financial outcomes are achieved for members over the long-term. However, we would anticipate numerous unintended and undesirable outcomes where risk adjusted returns are incorporated into an objective test with a binary outcome.

For example, if risk adjusted returns are assessed against a simple portfolio of equities and bonds, it would be difficult to determine the appropriate allocation to domestic and global bonds and equities, as well as the minimum cash exposure. These will vary substantially for different member cohorts.

The efficacy of using for example Sharpe ratio or a peer comparison is also not clear and would depend heavily on the threshold for failure. A fitted line versus peers will create continuous attrition over time as there will always be products below the line. Issues would also arise in terms of how to define "growth" and "defensive" to create the appropriate benchmark.

In our view, total risk adjusted returns would best be assessed against three criteria:

1. whether the product's return objective was met (was the fund "true to label");

2. whether the strategic asset allocation was suitable for the relevant cohort of members; and
3. whether the product's risk profile was appropriate in achieving the return.

This assessment could be undertaken by APRA in circumstances where a product fails the test. Giving APRA the discretion to apply this qualitative overlay to gauge the overall performance of a product in circumstances where it is difficult or inappropriate to apply risk measures in the assessment, or to account for material changes to the fund's strategy to address underperformance, would result in better outcomes for members. The discretion could allow APRA to, for example, consider a fund's broader investment governance arrangements in determining the final outcome and any conditions/future performance requirements.

This approach will likely reduce or eliminate reactionary risk-aversion and risk-taking behaviour and would allow APRA to consider alternatives to product closure in circumstances where the product's recent performance is strong and continually improving, or where the trustee has taken all reasonable steps to improve investment performance under the test. The closure of a product that has sufficient scale, strong recent performance, and/or has delivered on its investment objectives, will almost certainly be detrimental to the members who languish in the closed product for any period while assets are being wound down.

Modification 3 – Additional benchmarks

Under the current test listed/liquid asset classes are generally well covered by the existing benchmarks. We have previously argued for the addition of a new dedicated benchmark for Australian inflation linked bonds, which given the elevated inflation environment, would be a valuable addition to fixed income allocations. However, we acknowledge APRA's data limitations in this area and note that this is a good example of the limitations of an objective test.

Direct assets are the main area where, due to the idiosyncratic nature of these investments, there is a lack of suitable/recognised benchmarks. The addition of the global direct property benchmark was a good complement to the Australian property benchmark. Gaps remain for other direct assets including Private Equity and Private Debt, and ESG/sustainable options. This is likely to be discouraging investment in a range of assets, such as social housing and climate infrastructure, because these types of investments are not represented in the test benchmarks.

It is not feasible to select one or more sustainable benchmarks for the test. The screening and construction methodology of sustainable indexes mean each trustee's portfolio will be very different in terms of stock, sector, and country weights. As we have said in previous submissions, one way to address this issue would be to allow trustees to specify the customised sustainable benchmark to be used for the performance assessment as part of the SPS550 reporting. APRA could then provide guardrails/check and balance on trustees' selection processes.

Modification 4 – Blended (public/private) finance funds as a new benchmark

Another way to address the issue with a lack of social/sustainable benchmarks would be for the Government to partner with private capital and co-invest in one or more collective investment vehicles to fund these priority areas and make these funds the benchmark for testing purposes.

Blending public and private funds and pooling the investments of multiple institutional investors would create scale quickly, giving the funds an improved return profile from the outset. Smoother returns over the period of investment would also make investment in these types of funds comparable to other more developed market investments, which would help trustees to assess the option in the context of their fiduciary duty to members. The Government could provide for different incentives, such as tax, grants, price/return guarantees, etc, to be applied at the fund level to assure strong financial returns for underlying investors. With strong return profiles, these funds would make an ideal benchmark for testing purposes and would allow trustees to get exposure to these assets for their members by investing into these funds or into other sustainable investments that deliver similar outcomes for the benefit of members.

We welcome further discussion on any of the points that we have raised in this submission. Any questions in relation to this submission should be directed to Eve Brown at the contact details below.

Yours faithfully,

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