London Stock Exchange Group plc
10 Paternoster Square
London
EC4M 7LS

Telephone +44 (0)20 7797 1000
lseg.com

April 2024

LSEG response to the Australian Treasury's consultation on design options for the annual superannuation performance test

About LSEG

London Stock Exchange Group ("LSEG") is a leading global financial markets infrastructure and data provider, trusted to deliver excellence by customers, partners and markets around the world. We play a vital social and economic role in the world's financial system. With our trusted expertise and global scale, we enable the sustainable growth and stability of our customers and their communities.

LSEG offers benchmark and index solutions through FTSE Russell. FTSE Russell is a global index provider of benchmarks, analytics, and data with capabilities across asset classes. FTSE Russell's indices are used by clients to inform asset allocation decisions, support portfolio construction and conduct risk and performance analysis. FTSE Russell has two authorised benchmark administrators:

- FTSE International Limited ("FIL") is authorised in the UK by the Financial Conduct Authority (FCA) under the UK Benchmark Regulation ("UK BMR"); and
- Refinitiv Benchmark Services Limited (RBSL) is authorised in the UK by the FCA under the UK BMR and designated as a benchmark administrator for CDOR under the Canadian Securities Administrators Benchmark Rule ("CSA Benchmark Rule") and Ontario Securities Commission Rule 25-101 ("OSC Rule").

FTSE Russell is a longstanding provider to the Australian market. We currently have an estimated AUD$67 billion in Mandates and are the index provider for 13% of ETFs (by market capitalisation). FTSE Russell is also the benchmark for Listed Property and Listed Infrastructure under the Australian Prudential Regulation Authority's (APRA) MySuper Heatmap regime.

To ensure that indices are constructed, maintained, and operated to the highest standards, FTSE Russell employs a robust governance framework to approve new indices and changes to the methodologies of existing indices. The framework combines specialist decision-making bodies with members drawn from first line executive management, an oversight committee structure and independent external advisory committees formed of market practitioners with specialist expertise on benchmark methodologies, input data and the underlying market.

Introduction

LSEG welcomes the opportunity to provide feedback on Treasury's annual superannuation performance test framework.

We strongly support the intention of the performance test, to ensure that superannuation funds are managed efficiently and that trustees are held to account for their investment performance. However, we agree with Treasury's assessment that there are several unintended consequences of the performance test framework that are detrimental to member outcomes. We have two primary areas of feedback in relation to the performance test framework, which correspond to the ‘Design options’ section of the consultation. We have set these out in detail below.

Before we outline this feedback, we would first like to provide our perspective on some of the ‘stakeholder concerns’ outlined in the consultation paper.

Incentive to Hug Benchmarks: The concerns raised on this theme point to anecdotal evidence that suggest the performance test has created incentives for most superannuation funds, if not all, to ‘manage to the test’ and seek to minimise their tracking error against the regulated benchmarks selected for each asset class.

Whilst it is plausible that ‘some’ superannuation funds may seek to manage the test and ‘hug the benchmark’, FTSE Russell, as a provider of two of the selected benchmarks, has not observed any wholesale move to passive investment.

Best estimates of ‘passive’ or ‘index’ investments, places these investments of approximately 20% of the overall superannuation funds. This indicates that the Australian Pension pool is still largely an active investment management market, especially when compared with Europe and America, where the figure is estimated at over 50%.

Additionally, whilst we agree in principle with the concern raised in relation to **Reduced choice, diversification and active management**, we again question whether trustees prioritise passive investment strategies as outlined above.

Last, while we have also observed evidence that trustees can adopt passive strategies to lower their fees, we question the conclusion that investing passively lowers net returns in the long term. There exists long term quantitative research, across many asset classes, demonstrating that relatively very few active investment funds outperform their index benchmarks, after fees.

Design Options

<u>Option 1: Status quo – SAA Benchmark Portfolio</u>

We acknowledge that the current performance test has been effective in increasing fund managers’ accountability, removing underperforming products from the superannuation system and encouraging consolidation in the number of products available.

However, we also note that the current framework has resulted in several unintended consequences which should be addressed.

We agree with Treasury’s assessment that the current structure encourages superannuation funds to ‘manage the test’ by investing only in the selected benchmarks (albeit not en masse), overlooking those that may be more suited to their investment strategy, values and long term aims.

In addition, we are of the view that the current regulated benchmark portfolio selection structure introduces a significant moral risk for Treasury, by acting as an unofficial government endorsement of individual market players, encouraging investment in the selected benchmarks above other, potentially more suitable, options.

Not only does this contribute to limiting investor choice, but it also does not support fair competition within the market. This has resulted in anecdotal feedback that suggests some benchmark providers have been able to take advantage of their position as the selected regulated benchmarks and set fees accordingly.

LSEG Recommendation – Targeted revision of the status quo.

To address these concerns, we recommend a minor amendment to the current performance test that would allow **each superannuation fund to select their own preferred index benchmark** against which to measure their performance or to use for index tracking.

This approach would give funds the flexibility to choose a benchmark that aligns with their investment strategy and objectives, while maintaining the protections delivered by the performance test. It would ensure accountability for delivery against investment objectives and allow for greater diversity, choice, and innovation within the superannuation system.

Moreover, it would then align Australian superannuation funds with the approach large pension fund asset owners in other markets take, where they select their own "Policy benchmark" per asset class and monitor their performance against.

Targeted amendments to the existing process, would also ensure comparability, market understanding and would place limited additional requirements on superannuation funds.

The selected benchmarks should continue to be robust, objective, and reflective of a fund's investment approach. To ensure this, a **clear and balanced framework to govern the benchmark selection could be developed.**

We have set out below several key principles that could be adopted, to ensure that funds maintain the current high standards when selecting appropriate benchmarks.

- **Transparency and Disclosure**: Funds could be required to clearly disclose their chosen benchmark to their members and stakeholders. This transparency will enable members to understand how their funds are being measured and make informed decisions about their investments.
- **Performance Reporting**: Funds could be required to regularly report their performance relative to their chosen benchmark. This reporting can help stakeholders assess the fund's ability to meet its investment objectives and hold them accountable for underperformance.
- **Continuous Improvement**: Funds could be encouraged to periodically review and reassess their chosen benchmark to ensure its' relevance and appropriateness over time. This process of self-reflection would help funds make necessary adjustments and improve their accountability to members. Where considered necessary, third-party opinions could be utilised to support funds own assessment.

In conjunction with funds self-selection governed by these principles, we also **consider Treasury to play a crucial role in ensuring appropriate benchmark selection by funds**. To support this, Treasury could consider undertaking the below actions, in co-operation with the relevant regulatory authorities:

- **Selection Guidelines:** Treasury and appropriate regulatory authorities could develop guidelines, providing criteria for funds' benchmark selection. These guidelines could be based on existing best practice and would ensure that only those benchmarks that adhere to appropriate governance standards are permitted for selection. Criteria for selection could include:
    - A record of providing indices to the market for a significant number of years.
    - Compliance with the IOSCO Principals for Financial Benchmarks.
    - Sufficient assets benchmarked and already tracking indexes (e.g. over US$10 trillion) to ensure appropriate coverage, including international coverage.
    - Transparency on underlying methodology data used for benchmark creation, to ensure it is of sufficient quality and resilience.

Alternatively, and to ensure simplicity, Treasury could consider maintaining the current panel of index providers (conditional on adherence to the above criteria) but remove the asset class specific allocation. This would maintain the current high standards of benchmarks permitted to be utilised in the performance test, while also offering funds the flexibility to select benchmarks most aligned with their investment strategy.

- **Oversight and Monitoring:** Regulatory authorities could conduct regular oversight and monitoring of funds' benchmark selection practices. This could involve reviewing the rationale behind benchmark choices, evaluating the appropriateness of selected benchmarks, and ensuring compliance with regulatory guidelines.
- **Audit and Enforcement**: Regulatory authorities could ensure compliance with benchmark selection guidelines through audits and inspections.

Option 4 – Alternative framework

Second, we support the Treasury's assessment that the current test framework lacks the flexibility required to support values driven investment and disincentivises investment in emerging and alternative asset classes, such as those linked to climate and sustainability.

As the world's 4th largest pension market, Australian superannuation has significant capital which could be deployed to drive Sustainable Investment (SI) across asset classes and contribute to enabling the transition to Net Zero.

However, under the current performance test framework, the select group of market cap – weighted benchmarks do not properly account for SI, meaning the test effectively acts as a disincentive for investing for meaningful SI and climate transition portfolios and outcomes.

To enable investment into alternative asset classes, such as climate transition, through a transparent and controlled mechanism, we suggest a **combination of self-selected benchmarks as outlined in Option 1 above, alongside the widening of the tracking error allowance** for such funds**.**

Utilising climate transition investments as a case study, we propose the testing and assessment of a new Climate Transition Portfolio (CTP). The CTP would be consistent with the existing SAA reference portfolio calculation, with the performance of climate transition investments assessed against the performance of the market cap-weighted benchmarks as selected in Option 1 above.

Utilising multiple climate methodologies and data sets, our analysis shows the average tracking error for climate transition index against that for Global benchmarks is, typically, between 1 to 2% per annum.

Analysis of the FTSE ASFA Australia 300 index and FTSE Global Equity Index Series (GEIS) Developed ex Australia universes using a climate transition approach, shows the FTSE ASFA Australia 300 index as having a long term 10yrs+ tracking error of around 3% per annum, with the last three years increasing to around 4% per annum.

Analysis of FTSE GEIS Developed ex Australia index, shows a long term 10yrs+ tracking error of around 1.3% per annum, with the last three years increasing to around 2% per annum.

Based on this data, we would suggest that a widened tracking error budget of up to 200bps (2%) of the self-selected benchmarks seems appropriate. This would apply only to climate investments, with the rest of a portfolio tested as per the current process.

This recommendation is not based on an expectation that climate investment will under-perform in the medium to long-term, but on the basis that climate investment is a long-term capital reallocation that the world is embarking on, and therefore there may be short-term under-performance relative to market-cap. A wider tracker error budget mitigates the risk of short-term under-performance leading to penalties under the performance test, thereby allowing funds to start climate investing in a meaningful way.

In terms of benchmark selection, the CTP criteria could be based on global best practice and align with other climate standards being introduced to the Australian market. A third-party certification scheme could also be considered, utilising existing market standards where appropriate.

This CTP approach allows for the dynamically changing landscape of climate transition data and climate investment approaches to be continually incorporated and updated in portfolios.

While we have utilised climate as an example, the principles suggested here could be adapted to other emerging assets classes that do not currently have expansive representation. It would allow for these options to develop, encouraging innovation, while at the same time maintaining oversight and appropriate safeguards for investors.

***

We hope you find these comments helpful and remain at your disposal should you have any questions.

David Ho: david.ho@lseg.com
Head of Pacific, Index Investments Group (IIG), FTSE Russell

LSEG

Zara Colvile: zara.colvile@lseg.com
Senior Manager, Government relations and regulatory strategy
LSEG