Submission – Annual Superannuation Performance Test – Design options

19 April 2024

Overview

The Responsible Investment Association Australasia (RIAA) thanks the Commonwealth Treasury for the opportunity to comment on options to improve the sophistication of the annual superannuation performance test (the performance test).

RIAA agrees with the Government that the current performance test has had the desired effect to remove underperforming funds. However, it has also had unintended consequences which has disincentivised the superannuation sector from long-term decision-making, taking advantage of investment opportunities in new and emerging sectors and being able to adapt to a changing future: one where a focus on decarbonisation and transitioning to a net-zero economy is crucial. This future will also see the need for fund managers to consider and incorporate other, non-climate sustainability factors into investment decision-making to remain competitive – as many already do (see below).

RIAA supports the Government reviewing the framework of the performance test and welcomes the breadth of consultation undertaken in the *Annual Superannuation Performance Test - design options Consultation paper*. We have set out below our views on each design option as well as a set of principles to guide the selection of the new test. Long-term investing for the purpose of providing retirement benefits is a complex proposition which interacts with the inherent complexity of the financial market. Properly measuring the value added by a trustee and ensuing trustee accountability is vital but will naturally reflect this complexity.

It's clear from the data that responsible investing does not forego financial return. For example, RIAA certified products performed on par with or better than benchmarks over the medium and long term, with particularly strong results across managed growth funds. Underperformance was recorded only over the short-term (1-year) in 2022, noting that global performance for responsible investment funds subsequently advanced over the first half of 2023.[1]

In preparing this submission, RIAA has been informed by its previous submissions to:

- The draft Sustainable Finance Strategy; and
- Exposure Draft: Superannuation Industry (Supervision) Amendment (Your Future, Your Super—Addressing Underperformance in Superannuation) Regulations 2023.

[1] **RIAA Benchmark report 2023**

About RIAA

The Responsible Investment Association Australasia champions responsible investing and a sustainable financial system in Australia and Aotearoa New Zealand. It is dedicated to ensuring capital is aligned with achieving a healthy society, environment and economy.

RIAA has more than 500 members and represents US$29 trillion in assets under management (AUM) globally, making it by far the largest and most active network of people and organisations engaged in responsible, ethical and impact investing across Australia and New Zealand. Our membership includes super funds, KiwiSaver providers, fund managers, banks, consultants, researchers, brokers, impact investors, property managers, trusts, foundations, faith-based groups, financial advisers and individuals. RIAA's membership makes up 75% of all managed funds in Australia.

RIAA achieves its mission through:

a) providing a strong voice for responsible investors in the region, including – as a mission-focused organisation with a broad group of members whose views may not always align – influencing policy and regulation to support long-term responsible investment and sustainable capital markets;
b) delivering tools for investors and consumers to better understand and navigate responsible investment products and advice, including running the world's first and longest-running fund certification program and the online consumer tool Responsible Returns;
c) supporting continuous improvement in responsible investment practice among members and the broader industry through education, benchmarking and promotion of best practice and innovation;
d) acting as a hub for our members, the industry and stakeholders to build capacity, knowledge and collective impact; and
e) being a trusted source of information about responsible investment.

Key principles for a solution

The proposed review of the performance test aligns with RIAA's position that a whole-of-government approach to sustainable finance is required. In its submission to the draft Sustainable Finance Strategy, RIAA called for a whole-of government approach to sustainable finance, recognising that the transition to a net-zero economy requires effort well beyond the finance and energy sectors, and involves all industries and all government portfolios. Sustainable finance will interact with and influence most, if not all, current and future initiatives through its role in financing Australia's transition to net-zero. In particular, under Priority 8 of the Sustainable Finance Strategy, *Ensuring fit for purpose regulatory frameworks*, RIAA submitted that it was crucial the Government prioritised resolving the potential unintended consequences of the performance test on the superannuation sector's ability to invest in this transition.

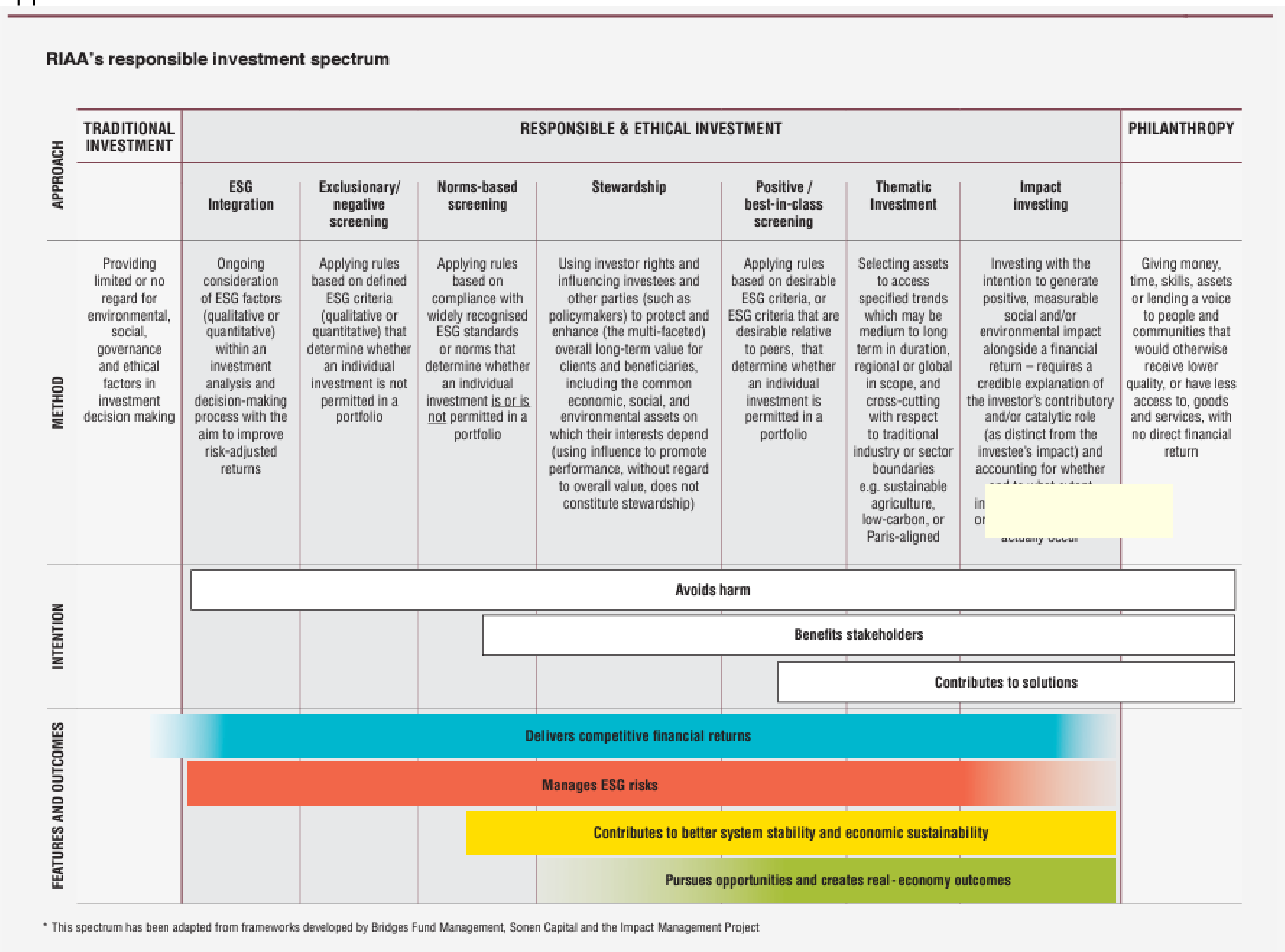
RIAA notes that, on 28 March 2024. the Senate Economics Legislative Committee handed down its report on the *Superannuation (Objective) Bill 2023*, recommending that it be passed. As previously submitted by RIAA, this soon-to-be legislated objective, which requires funds to generate retirement income in a 'sustainable' way, could conflict with the existing performance test for superannuation products. For instance:

- indices underlying the performance test do not incorporate negative screens or sustainable investment approaches. For example, the ASX/S&P 300 index, used for Australian equities, heavily weights towards resource companies and other stocks that may not align with sustainability goals;

- funds demonstrating responsible and sustainable investment practices, such as meeting RIAA Responsible Investment Product Certification and UN Global Compact Controversy exclusion screens, face an unstable tracking error against the performance test benchmark;[2] and
- the uncertainty and risk of being penalized for failing the performance test, could deter funds from robust investment approaches geared towards long-term sustainable returns.

RIAA wishes to make clear that responsible investment approaches as a whole have been shown to lead to improved risk/return outcomes. There are a number of super funds which implement market-leading approaches to responsible investment through default MySuper products and pass the current performance test, including organisations that have been named as [Responsible Investment Leaders](#) by RIAA. However, it remains the case that the short-term, benchmark-hugging nature of the test in its current form risks deterring funds from pursuing long-term sustainable investments. That is, the need to pass a single test every year, coupled with the serious consequences of failing to do so, could lead to passing the performance test being an overweighted consideration of trustee decision-making.

In addition, it is important to keep in mind that there are a number of different responsible investment approaches:[3]



Consistent with proper risk management practices and the development of market consideration of climate risk, ESG integration has been incorporated into general investment decisions-making, even in traditional investment strategies. If done correctly, ESG integration should improve the strategy's

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[2] Research by the Conexus Institute, [Constraints on ESG, Sustainability and Carbon Transition Activities](#) (November 2022)
[3] [Responsible Investment Explained - Responsible Investment Association Australasia (RIAA)](#)

performance relative to the relevant test. RIAA would expect all super products, including MySuper products, to incorporate a degree of ESG integration. However, the crucial detrimental impact of the performance test is greater for strategies which have a secondary objective (i.e. incorporate an approach great than ESG integration) and go beyond traditional risk and return outcomes. These are often seen in Choice products.

RIAA is overall agnostic on the framework selected by Government to reduce this risk, provided it is a proper solution and incorporates the principles below. RIAA acknowledges that there are a number of different views across industry regarding the appropriate approach (if any) to amending or replacing the performance test, including among RIAA's 500-strong member base. However, through wide consultation and engagement with funds that pursue different strategies and approaches, and considering the importance of a joined-up policy response to both the climate change crisis and transitioning the Australian economy to net-zero, as well as RIAA's mission,[4] we consider the current performance test to constitute a regulatory barrier which is, at present, disincentivising the superannuation sector to invest outside of a limited universe that tracks carbon intensive benchmarks.

Making appropriate changes would provide flexibility to consider investments which would have long-term benefits (consistent with the nature of superannuation) and would not require superannuation funds to drastically change how they manage funds on behalf of members. RIAA's 2023 Super Study found that 42% of super funds have portfolio targets aligned with the Paris Agreement (net zero by 2050), compared with just 34% in 2021. However, trustees must navigate the tension between a heightened likelihood of failing the performance test at some point or having to reduce the degree to which longer-term transition activities are implemented, potentially inconsistent with investing in accordance with the long-term financial interests of members, and/or with members' sustainability preferences.[5]

To ensure the performance test remains fit-for-purpose into the future, **RIAA recommends** Government establish an independent multi-disciplinary oversight body to ensure the ongoing relevance of the performance test. This should include industry and technical experts to ensure the test remains fit for purpose and is future-proofed to the extent possible.

In recognition of the differing views and the possibility of different kinds of solutions to the current performance test issues, RIAA has set out below a set of principles to guide the selection and provide a baseline for a test to ensure the Australian Government's overarching goal of transition is supported.

Principle 1
Any new test framework should be sufficiently flexible to include non-climate sustainability factors in the future

Any amendments to the current framework should be flexible to be able to be applied to non-climate sustainability factors in the future. While RIAA agrees with the Government's prioritisation of climate-first in its Sustainable Finance Strategy, RIAA submits that frameworks and policies introduced or adapted for climate (including changes to the performance test) should not be so rigid as to only be applicable to the issue of climate change. This recognises both the urgency of the climate crisis and the interrelated nature of all sustainability factors and, where the climate-related changes are sufficiently flexible, will allow for quicker application to non-climate sustainability factors. This will also recognise that, globally, markets are incorporating and building out issues beyond climate. Domestically, Australia already has mandatory reporting on non-climate sustainability factors – e.g. the *Modern Slavery Act 2015* and *Workplace Gender Equality Act 2012* and investors are rapidly looking towards nature and biodiversity risk. For investors, norms-based screening of investments grew 85% from $138 billion in 2021 to $255

[4] To promote, advocate for, and support approaches to responsible investment that align capital with achieving a healthy and sustainable society, environment and economy.
[5] Research by the Conexus Institute, Constraints on ESG, Sustainability and Carbon Transition Activities (November 2022)

billion in 2022. Amending the current test to only address climate or energy transition-related investing may necessitate further reform which may be costly and/or inefficient.

Principle 2

Any new test should be fit for long-term investments and respect consumer choice

The timeframes in the current performance test are not consistent with so-called "non-traditional" assets such as sustainability-related assets. RIAA contends that despite the Government in 2023 extending performance test lookback from 8 years to 10 years, aspects of the performance test will remain challenging while the formulation of the benchmark continues to limit investors' ability to deviate in search of longer-term outcomes.

Additionally, it is important to ensure performance benchmarks are established in a manner that aligns superannuation funds to invest consistent with delivering strong, long term investment returns, aligned to the time horizons of their beneficiaries. There are significant differences between the views of older and younger Australians. For example, RIAA's 2022 consumer research found that 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.

RIAA reiterates that a responsible investment approach does not risk or lead to underperformance (and therefore failing the existing performance test).

There is a greater diversity of offerings of responsible investment approaches in Trustee Directed Products or other Choice Products where consumers make an active decision to choose their preferred product. By not recognising the deliberate choice of consumers to follow a particular investment strategy, in many cases informed by their specific values, the performance test may fail products that are in fact delivering on members' investment choices or consistent with their specific beliefs, as well as delivering on financial return. This is contrary to the Government's objective for the performance test which includes improving member outcomes.

It is important to note that Choice Products are a diverse mix, and include single asset classes, and smaller ethical funds, and that any assessment of their performance should be understood in relation to the specific focus of the product, the objectives of the members, and the particular exclusions that could be a factor in driving a large tracking error.

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 2024: Charting consumer demand for responsible investing in Australia* found high expectations that funds will invest responsibly: 88% of Australians expect their bank account and their super to be invested responsibly and ethically.

Principle 3

Minimise and manage benchmark hugging

One of the critical issues with the current performance test is the manner in which it could encourage short-term decision making for a financial product which has its sole purpose as one which is long-term: to provide members with retirement benefits. The need to pass a test every year, coupled with the serious consequences of failing to do so, could lead to passing the performance test being a primary consideration of trustee decision-making.

Principle 4
Performance test should align with the sustainable finance taxonomy

RIAA considers the development of the sustainable finance taxonomy by the Australian Sustainable Finance Institute to be a critical development in supporting the sustainable finance industry. The objectives of the Australian taxonomy as outlined by the ASFI roadmap are to:

a) direct capital flows into economic activities that substantially contribute to climate mitigation and other sustainability objectives;
b) help guide an orderly and just transition to a sustainable economy; and
c) address greenwashing.

RIAA notes that the taxonomy has not yet been finalised. However, subject to the final taxonomy resulting in a credible, robust articulation of transition activities, any test, including its metrics and variables,[6] should aim to use the clear and consistent common definitions to be developed under the Sustainable Finance Taxonomy where it is eligible to do so (i.e. for Australian assets). Further consultation with industry will be necessary.

Principle 5

Aligns with and applies RIAA's Certification Program

Updates to the performance test which allow for longer-term sustainability considerations will likely require a process of credible third-party verification. Unlike existing benchmarks, it can be more difficult to ascertain whether a particular product is actually, and sufficiently, undertaking the purported approach. For example, if a Paris-aligned assets benchmark is added to the existing performance test, it will be important, to both market integrity as well as to regulators, that the product is a) investing in Paris-aligned assets and b) investing in such assets to a degree which warrants being measured against that benchmark. There may also be scope to use certification to ensure standards are lifted and maintained across the market. This is squarely within the work currently undertaken by the RIAA Certification Program.

> RIAA's Certification Program
>
> RIAA's Certification Program is informed and shaped by global definitions and standards with a local focus to ensure this labelling program aligns closely with the established and emerging labelling and classification systems for products globally. For example, RIAA worked with peer sustainable investment organisations through the Global Sustainable Investment Alliance (GSIA) who, together with the UN Principles for Responsible Investment (PRI) and the CFA Institute, developed and published in November 2023 definitive standardisation of the use of key terminology in RI – ESG Integration, screening, stewardship, impact and thematic investment – in the context of responsible investment.[7]
>
> In keeping with the move towards labelling for sustainable products, in May 2024 RIAA will launch its Sustainability Classifications Initiative (SCI) which will introduce product classifications informed by international standards (such as the three tiers in the SDR, SFDR and SEC guidance) for products, to differentiate them on the basis of their intention to consider, address or target sustainability objectives and impacts.
>
> RIAA Certification is focused on maintaining the rigour and credibility of the responsible investment sector and products in delivering this program. Consistent with the increased scrutiny on industry, RIAA's Certification Program continues to focus strongly on ensuring truth in labelling, including deep dive due diligence on products to ensure substantiation of claims made that would not mislead the average consumer.

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[6] As defined by Treasury in the consultation paper Annual Superannuation Performance Test – design options | Treasury.gov.au
[7] https://www.gsi-alliance.org/members-resources/definitions-for-responsible-investment-approaches/

Submissions on design options

<table>
<tr><th>OPTION</th><th>RIAA'S SUBMISSIONS</th></tr>
<tr><td rowspan="3">Option 1 Current Test</td><td>RIAA does not recommend maintaining the current performance test in its current form.
Having removed or improved the underperformers, the current performance test is no longer properly measuring underperformance of the superannuation sector, regardless of the investment approach.
The following elements of the test risk disincentivising the pursuit of long-term sustainable returns:
• the carbon intensive benchmarks currently used, which do not align with the Paris Agreement or Australia's emissions reduction targets;
• the timeframe used for the lookback period; and
• encouraging short-term decision making to pass the following year's performance test result.</td></tr>
<tr><td>RIAA is of the view that the Government should pursue a framework that encourages a move away from using benchmarks anchored in the short-term performance of carbon-intensive groups of companies as the norm.

Should the Government opt to implement adjustments to the current performance test in the short-term, RIAA recommends the Government amend the following two distinct areas:
1) the performance test framework; and
2) the indices used under the performance test. For either of these, we consider that at a minimum, the principles outlined above should be met.</td></tr>
<tr><td>If additional benchmarks are added, consideration should be given to cost and competition, with appropriate guardrails, as well as ensuring appropriate and transparent process for the selection of additional reference portfolios, taking into account such factors as forward-looking, representative, transparent and (ideally) investable

RIAA is aware of a number of existing benchmarks that may fit this purpose. The following is one example of an existing benchmark that RIAA considers would be an appropriate addition under the existing performance test and aligns with the Government's climate-first approach. This has been informed by research by FTSE Russell and London Stock Exchange Group who have worked with RIAA to develop this option.</td></tr>
</table>

	• This possible solution involves the introduction to the regulation a secondary Climate Transition Portfolio (CTP) option, with a higher aggregate performance test tracking error budget at the portfolio level. This budget could then be utilised proportionally to the assets invested in climate transition approaches which meet the criteria of the CTP. • This should give a good degree of flexibility for Climate Transition Investing whilst staying consistent with the portfolio performance test approach of the existing regulation. • **Attachment 1** provides additional information and suggests criteria for the CTP could incorporate companies' climate governance activities (for example, aligned with the Taskforce on Climate-related Financial Disclosures' recommendations), and/or forward-looking commitments to carbon emission pathways (aligned to the Paris Agreement and 2DC/1.5DC warming scenarios).
Option 2 Alternative single-metric test – Risk-adjusted returns a) Sharpe Ratio b) Peer Comparison c) SRP Frontier	RIAA recommends consideration of Option 2, where allowing for both financial and non-financial factors could provide flexibility for trustees to invest more broadly over the longer-term, including in support of the transition to a net-zero economy.
Option 3 Multi-metric Framework a) Heatmap Framework b) Targeted-Three Metric	RIAA recommends consideration of Option 3, consistent with its view that the performance test, while it should not be unduly complicated, will require a sophisticated framework to be able to measure a complex proposition. RIAA considers that using the APRA Heatmap as an aspect of the performance test may be useful, where metrics are reviewed to ensure consistency with both Legislation (e.g. the Objective of Superannuation) and APRA Guidance (such as SPG 530). It would not be appropriate to apply the existing APRA Heatmap without review. For example, where an investment strategy has secondary objectives (i.e. sustainability objectives) that go beyond traditional risk and return outcomes, then these 'non-traditional' objectives should be considered when evaluating the performance test. The expectation is that providers of responsible investment options would already be measuring and evaluating the outcomes that they have promised to their clients (the sustainability objectives). As an option, the Government may wish to consider the proposal of incorporating assessment against the multi-metric heatmap framework in cases where a product fails the performance test, thereby allowing a more detailed appraisal on the nature of the product's failure of the first test.
Option 4 **Alternative frameworks**	RIAA is overall open to any option that meets the principles above, and resolves the issues identified with the current performance test.

Your Future, Your Super

Evolution for Climate Transition Investing

This proposal has been developed with Responsible Investment Association Australasia (RIAA), of which LSEG is a member, and consulted through RIAA's Policy Technical Expert Group of RIAA members.

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Executive Summary

SITUATION

- As the world's 4th largest pension market, Australian Superannuation has significant capital (approx. USD 2.4 trillion) which could be deployed to drive Sustainable Investment (SI) across asset classes and contribute to enabling the climate transition to Net Zero.
- Under the 'Your Future, Your Super' regulation, a performance test is applied to reported Strategic Asset Allocation at the portfolio level, across eleven main asset classes based on selected market cap-weighted benchmarks. These benchmarks do not take account for SI and failure of the performance test risks severe penalty.

OBSERVATION

- Beneficial effects of the performance test are that the tight tracking of the mandated benchmarks helps to ensure risk-weighted returns and appears to drive efficiencies including the consolidation of the Superannuation industry.
- However, the test acts as a significant constraint on taking active risk against the benchmarks, which restricts meaningful SI and climate transition portfolios and outcomes.

RECOMMENDATION

- To maintain the beneficial effects whilst also enabling climate transition investment through a transparent and controlled mechanism, a secondary "Climate Transition Portfolio (CTP)" could be introduced, whereby climate transition investments are assessed against an appropriately widened performance test threshold at the SAA portfolio level.
- The calculation of the CTP would therefore be consistent with the existing SAA reference portfolio calculation, with the long-term performance of climate transition investments assessed against the performance of the selected market cap-weighted benchmarks.
- The CTP criteria could be based on global standards and best practice, and align with other climate standards which are being introduced or are under regulatory consideration for the Australian market.

Climate Transition Portfolio (CTP) – Supporting Data

Tracking error ranges to benchmark for meaningful climate transition – example of Global equity/Australian equity

- Looking at average tracking error to the benchmark taken for climate transition index implementations using different climate methodologies and data sets, analysis shows that for Global benchmarks these tend to be around 1-2% per annum.
- Additional analysis on the Australia 300 and Developed ex-Australia universes using a climate transition approach, shows Australia 300 having a long-term 10yrs+ tracking error of around 3% per annum, with the last three years increasing to around 4% per annum. Developed ex-Australia has a long-term 10yrs+ tracking error of around 1.3% per annum, with the last three years increasing to around 2% per annum.*
- SAA portfolios Conservative/Balanced/Growth, market-cap v climate indices assessment summarised on the following slide.

Potential criteria for the CTP, with reference to global standards

Looking at global standards and approaches, there are two main areas to consider incorporating;

a) Companies' climate governance activities (aligned with the Taskforce on Climate-related Financial Disclosures' recommendations)

b) Forward-looking commitments to carbon emission pathways (aligned to the Paris Agreement and 2DC/1.5DC warming scenarios).

There are different approaches to frameworks and data that capture these principles – which may also align with other Australian regulatory approaches under development - this can be discussed further in consultation with market participants.

*Based on FTSE Russell data/simulations and estimated portfolios

LSEG

Strategic Asset Allocation – TE/Performance Analysis

Comparison of Conservative/Balanced/Growth SAA, Market-cap vs Climate Indices*

	Conservative	Balanced	Growth
1yr TE	1.38%	1.53%	1.62%
5yr TE	1.72%	1.96%	2.12%
1yr Perf.	-0.88%	-1.17%	-1.36%
5yr Perf.	0.52%	0.89%	1.37%

CONCLUSIONS

- Analysis shows Climate Transition Portfolio outperforms the Standard Portfolio by **0.52-1.37%** over last 5yrs, with short-term (1yr) under-performance.
- 5 Yr Tracking Error **1.72-2.12%.** Current YFYS performance test allows for 0.5% underperformance over 8yr lookback.
- Proposal to widen performance test threshold to **2% over 5 years** for Climate Transition Portfolio (CTP) assets.

*Based on FTSE Russell data/simulations and estimated portfolios

Climate Transition Investing - Case Studies, Global Asset Owners

Examples of implementation/best practice from Global Asset Owners for investment in climate transition

See supporting documents for three Climate Investing implementations;

- New York State Common Retirement Fund
- The Church of England Pensions Board
- Brunel Pensions Partnership

Common themes that link the three are:

a) To meet the minimum carbon emission reductions of the Paris-aligned benchmarks

b) Forward-looking metrics and governance protections

c) Mitigating the financial risk of climate change to protect pension holders

All 3 Climate Investments outperformed over last 5 years (3.6%-21.1%)

INDEX PERFORMANCE

Total Return - 5 years (data as at 30 June 2023)

	%	% p.a.
NYSC		
Russell 1000 TPI Climate Transition Index	81.2	12.6
Russell 1000 Index	75.6	11.9
CofE		
FTSE Developed ex Korea TPI Climate Climate Transition Index	60.8	10
FTSE All World Developed ex Korea Index	57.2	9.5
Brunel		
FTSE Developed Paris Aligned Benchmark Index	77.4	12.1
FTSE Developed Index	56.3	9.3

Points For Further Consultation

1. If the Climate Transition Portfolio (CTP) was introduced effective 01 July 2024 with the proposed performance test threshold of 200bps over a 5year lookback, what would be the main considerations for implementation, and are the bps/time parameters feasible?

2. Which climate criteria should be incorporated for investments to be eligible under CTP? Example considerations could include:
- emissions reductions targets
- scope 1&2 only or include scope 3
- inclusion of forward-looking projections/models
- minimum standards for inclusion

3. Are there any other considerations the CTP should factor in? For example:
- alignment with disclosure standards, such as TCFD
- sector/geographic/factor neutrality
- turnover constraints

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