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Superannuation Efficiency and Performance Unit
Retirement, Advice and Investment Division
Treasury

Submitted electronically

To whom it may concern,

Climateworks Centre submission on the Annual Superannuation Performance Test

Climateworks Centre bridges the gap between research and climate action, operating as an independent not-for-profit within Monash University. Climateworks develops specialist knowledge to accelerate emissions reduction, in line with the global 1.5°C temperature goal, across Australia, Southeast Asia and the Pacific.

We appreciate the opportunity to provide feedback on Treasury's consultation paper regarding design options for the Your Future Your Super (YFYS) Annual Superannuation Performance Test (the performance test).

The climate wave investment opportunity is now

There is now a clear and timely opportunity to align the Superannuation sector to our Sustainable Finance Strategy and developing sustainable finance policies for 1.5°C pathways, to turbo charge Australia's ambition to become a green 'superpower'. This can be achieved through simple amendments to the performance test, using a **multi-metric framework 3b. Targeted three-metric option.**

Climateworks recommends that:

- Treasury endorses the 'Column B' list of net zero 1.5°C-aligned indices across all asset classes within the current performance test benchmarks.
- A carve out is available for climate-aligned investments that do not have a clear benchmark.
- A clear warning label is included within member reporting for all superannuation funds that have significant exposure to climate risks.

Our detailed feedback and recommendations are outlined in this submission.

The performance test aims to safeguard Australians' retirement savings by holding trustees accountable for investment performance and fees. Whilst the performance test has been largely successful in its primary objective, serious unintended consequences have emerged, leading to a large shift in investment strategies that have sidelined climate investment within the $3.6 trillion superannuation industry. This needs to change.

All evidence indicates a genuine desire within the superannuation sector to seize the opportunities presented by the climate investment wave. Every effort must now focus on eliminating any obstacles to this goal. The first of these is to include climate-aware indices in the performance test.

Considerations in the current YFYS design

Alignment with 1.5°C pathways ensures the performance test remains in step with the Australian sustainable finance taxonomy project, which is driven by the Australian Sustainable Finance Institute (ASFI). ASFI has strong support from the Council of Financial Regulators (CFR 2021) to drive this work forward. The CFR recognises the risks to Australia and our financial system if we are not actively shaping emerging international norms in this area to suit Australia's interests.

Several components in the current design of the test must be reconsidered, and key barriers overcome. These considerations include:

- **Fiduciary duties:** As long-term investors with a legal obligation to act in the best financial interests of beneficiaries, superannuation funds must consider climate risks and opportunities in their investment decisions.
- **Member best financial interests:** Climate risks are essential to consider for investments spanning 50+ years. Consideration of these risks will maximise long term investment returns for all members.
- **Investment alpha:** Leveraging investments' readiness for climate change and seeking alpha through climate opportunities is imperative for superfunds to remain competitive.
- **Index transition is not fast enough:** Indices selected in the test are not adapting to climate risk. Indices will transition, but this is not happening fast enough. The ASX 300 is a high emission intensive index. Super funds have a home bias in asset allocation with most Australian equity positions in a balanced fund sitting around 25%. Australian Super Balanced option allows an asset allocation of up to 45% in Australian shares with the current tactical asset allocation currently at 23.5%.
- **Policy alignment gap:** Current design lacks alignment with 1.5°C sectoral pathways, the government's sustainable finance agenda and existing policy such as the climate-related financial disclosures.
- **Sustainable Finance Taxonomy:** Taxonomy methodology has adopted a 1.5C alignment which is supported by key players finance industry peak bodies ACSI, ASFI, Investor Group on Climate Change (IGCC) and Responsible Investment Association Australasia (RIAA).
- **Unpriced climate risk:** Current market pricing may not adequately account for climate risks, leading to uninformed investment decisions through conformity with non-climate-aware indices.
- **Market constraints:** Current legislation is a direct barrier to capitalising on green investments and does not support elevating ambition of underlying investments as they need to hug the benchmark.
- **Backwards-looking practices:** Existing practices often overlook forward-looking prospects and fail to adapt to changes that could improve long-term performance.
- **Greenwashing**: The risk of greenwashing is heightened by not aligning investment strategy and stated ambition with appropriate indices.

A multi-metric framework to include climate-aligned investments

Amending the performance test using a multi-metric framework will enable the superannuation sector to align with 1.5°C pathways as per other sustainable finance policy initiatives, and enable investments to be true to label with the fund's stated climate ambition.

We support performance as the metric, with the following inclusions considered in the performance test:

- Net zero 1.5°C-aligned indices performance across all asset classes
- Carve out to accommodate non-benchmarked assets with a climate thematic

These amendments will support capital flow into climate-aligned investments and raise climate ambition and capabilities across Australian investment markets.

Climateworks is currently developing a multi-metric framework for these purposes, which, when completed, we intend to share with Treasury for consideration.

Enabling climate-aligned investments and removing existing barriers through applying a multi-metric framework to the performance test will:

1. Ensure fiduciary duty is met
2. Support members' best financial interests and support their right to select appropriate investment options
3. Optimise long term investment returns and capture investment alpha
4. Align the ambition of YFYS with other sustainable finance policy including climate-related financial disclosures and the Sustainable Finance Strategy
5. Enable investors preparedness for climate investment risk
6. Catalyse sustainable finance flows
7. Provide shared climate investment between government and private markets
8. Provide forward-looking, fit for purpose, climate-aware indices
9. Mitigate greenwashing risk by ensuring product's label are aligned to investment strategy and appropriate benchmark
10. Future proof Australia's superannuation industry and maintain Australia's world-leading pension status

Ultimately, this will raise the climate ambition and capabilities of Australian investment markets on the global stage.

Climateworks' credentials

Climateworks has fifteen years of experience accelerating climate transitions across multiple sectors.

We have co-developed a climate-aware ASX300 reference portfolio, using our scenario modelling and through a collaboration with ISS ESG Australia and the Monash Centre for Quantitative Finance and Investment Strategies. This reference portfolio was used as a foundation by BNP Paribas for Project Green Kangaroo, the first Australian equities index with a specific forward-looking focus on climate transition and decarbonisation, launched in August 2020. This project garnered initial investment from Clean Energy Finance Corporation (CEFC), Aware Super and QBE Insurance, demonstrating substantial industry support and market significance.

The reference portfolio identifies those Australian listed companies most likely to prosper through, and play a part in achieving a 1.5–2°C future: those most likely to capture the transition opportunities, adapt to the risks, or be least affected by the transition. The reference portfolio companies' rankings are the result of rigorous scenario analysis, assessment of companies' risk mitigation strategies, assessment of different sectors of the economy and how companies plan to adapt to these changes.

Independence is critical for Climateworks to maintain our independent and objective approach to research and climate solutions. Our independence in this project is ensured, as our fees are not tied to performance metrics or the amount invested. Compensation is solely based on the independent maintenance of the reference portfolio.

Normalising 1.5°C alignment in superannuation

Incorporating credible 1.5°C-aligned indices within the performance test should be the first priority to normalise 1.5°C alignment in superannuation.

Drawing on insights gained from constructing our reference portfolio over the past four years and our fifteen-year history in accelerating climate transitions, Climateworks is developing the 'Normalising

1.5°C in superannuation' project, being run by our Sustainable Finance team. This project will involve a multi-stakeholder approach across member groups, capital allocators, index providers and government.

Climateworks proposes a six-step approach for the Treasury to adopt, to align the performance test with the government's sustainable finance agenda. The first step and most important step in this project, is to support Treasury to secure a place for fit-for-purpose 1.5°C-aligned indices across all asset classes in the performance test.

1. Endorse the 'Column B' list of 1.5°C-aligned indices

Recommendation 1: Treasury to endorse the 'Column B' list of 1.5°C-aligned indices across all asset classes within the current performance test benchmarks.

- In doing so, it is vital to ensure that indices are fit-for-purpose as determined by an independent review.
- Optional uptake of 1.5°C-aligned index per asset class, or recognising non climate-aligned assets within a portfolio.
- This can be either a single or composite per asset class, to enable transition or partial alignment, with mandatory uptake for climate-aligned labelled products.
- An oversight process incorporated to ensure continuing best-practice indices are used in a fast-moving market.
- Climate should be the first priority in these indices, but other priorities (such as nature or social impact) can be incorporated over time.
- Negative screening may be implemented to provide an approach for fossil-fuel free portfolios.

2. Independent review of existing indices

Climateworks will conduct an independent review of existing indices. This review aims to provide the Treasury with a comprehensive report evaluating existing 1.5 aligned indices across all asset classes by June 2024.

The Climateworks report will cover:

- **Establishment of criteria for a credible 1.5°C-aligned index** with input from global networks like the Glasgow Financial Alliance for Net Zero. The report will define what good looks like and build a minimum standard.
- **Current credible 1.5°C-aligned index review** evaluating existing indices that meet the criteria for a credible 1.5°C-aligned index.
- **Population of 'Column B' of the performance test** with currently available fit-for-purpose indices per asset class.
- **Gap analysis**: Identifying asset classes lacking a credible 1.5°C-aligned index.
- **Current 1.5°C-aligned index/closest fit methodology:** Assessing the closest-fit methodology of current indices against the 1.5°C standard and identifying shortcomings.
- **Non-benchmarked assets:** Highlighting asset classes lacking a suitable climate-aware index such as Small Caps, Private Equity or Venture Capital.
- Performance history: Backtest performance history of our climate-aware ASX300 reference portfolio

3. Industry project to fill gaps

The independent review focuses on identifying gaps in 1.5°C-aligned climate indices across all asset classes.

The industry project, which Climateworks will commence following the review, will work towards solutions to fill the gaps and highlight guidance where required, including:

- Pinpointing indices that are the closest fit to the 1.5 aligned standard

- Assessing the capacity to modify methodologies in line with 1.5 aligned standard
- Coordinating stakeholders to develop missing indices
- Suggesting alternative solutions for non-benchmarked assets, such as a carve out
- Other research required to fully populate ‘Column B’
- Guidance notes required or exceptions where relevant

> **Recommendation 2:** Carve out a provision that allows for new assets and climate-aware investments, for non-benchmarked investments.

We recommend carving-out a provision that allows for new assets or climate-aware investments, which may not align with any benchmarks. Strategic Asset Allocation for a Balanced fund to Private Equity can range from 0-15 per cent. We would suggest that a range of 5-10 per cent of the funds under management (FUM) be non-benchmarked. The performance could use a proxy such as the Bank Bill Index or Global Bond Aggregate Index. This provision encourages innovation and flexibility while maintaining a balanced approach towards climate-aligned investments within the superannuation sector.

4. Industry Capacity building

Climateworks will also focus on industry capacity building to ensure market uptake of credible indices. Given Climateworks' affiliation with Monash University, renowned for its leading climate education and business training, we are in a unique position to facilitate ongoing capacity building – educating and supporting stakeholders to understand and adopt credible indices aligned with 1.5°C goals.

Additionally, we can leverage existing programs of work to facilitate industry capacity building. For example, ASFI is working with key stakeholders and a recently established Capability Reference Group to develop Australia’s first Sustainable Finance Capability Framework. This framework demonstrates the key skills needed for individuals to perform various roles in sustainable finance.

5. Member communication

> **Recommendation 3:** A clear warning label is included for all superannuation funds that have significant exposure to climate risks. The clear warning should be included in offer documents and included within regular member performance and asset allocation reporting.

The RIAA FROM VALUES TO RICHES 2024: Charting consumer demand for responsible investing report highlights that in Australia, climate change remains another key concern for Australians thinking about their investments. Seventy-six per cent of Australians want their funds and banks to make formal commitments to reach net zero emissions by 2050. Currently there is clear misalignment between what members expect and what superannuation funds are able to deliver. Where a fund has significant exposure to climate risk, has not made formal commitments to reach net zero emissions by 2050 or is not on track via a credible transition plan to reach net zero emissions by 2050, members should absolutely be informed of this, along with their fund’s reporting requirements including performance and asset allocation.

6. Governance and oversight to ensure continuing fit for purpose

To maintain the integrity of this process, it is crucial to establish sufficient governance and ongoing oversight. This ensures the currency of indices methodology and utilisation of best available data, enhancing the credibility and effectiveness of the climate-aligned indices within the performance test. Climateworks will consider this governance within our independent review and report possible solutions to the Treasury in June 2024.

Submission summary

The submission emphasises the need for the Superannuation sector to align with our Sustainable Finance Strategy and the developing policies for sustainable finance pathways towards the 1.5°C goal. It is crucial that any adjustments to the YFYS performance test, drive investments aligned with climate goals, to ensure the resilience of Australia's Superannuation industry and uphold its leading global pension status.

Working within Monash University, as an independent not-for-profit, Climateworks is well positioned to support Treasury in this endeavour. Our focus is on practical market solutions that meet the necessary criteria, can be implemented efficiently and address Australian members' strong preference for climate risk consideration and opportunities in a 1.5°C-aligned economy.

This approach, most importantly prioritises the best financial interests of Australian superannuation members, reflecting their strong desire for their superannuation funds to factor in climate risk and seize long term opportunities in a 1.5°C-aligned economy.

Thank you for taking the time to consider Climateworks’ Submission.

We will provide the outlined research report and high level framework for 1.5°C-aligned credible indices by June 2024, along with an invitation to further discuss the report and proposal with Treasury.

Yours sincerely,

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