PRI RESPONSE

ANNUAL SUPERANNUATION PERFORMANCE TEST- DESIGN OPTIONS

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To inform this briefing, the following investor group has been consulted: PRI Collaboration Platform and Australia RPRG. This consultation is not an endorsement or acknowledgement of the views expressed in this briefing.

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ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

The PRI develops policy analysis and recommendations based on signatory views and evidence-based policy research. The PRI welcomes the opportunity to respond to the Treasury call for feedback on design options for the annual superannuation performance test.

ABOUT THIS CONSULTATION

The Treasury Laws Amendment (Your Future, Your Super / YFYS) Act 2021 received royal assent on 22 June 2021 with supporting regulations made in August 2021. YFYS measures aim to increase member engagement, reduce fees, improve performance, and hold trustees to account for their decisions. They include measures such as the YourSuper comparison tool, stapling, best financial interest duty (BFID), and the performance test. The YFYS Review in 2022 sought stakeholder feedback on unintended consequences and implementation issues arising from the YFYS legislation – findings were consolidated in a 2023 report.

The consultation paper published on 8 March builds upon findings from the YFYS Review, particularly focusing on the performance test aspect of the YFYS legislation. The paper canvasses a range of options for reforming the test, which will be considered if the government decides to do so in the future.

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KEY RECOMMENDATIONS

The PRI welcomes the Treasury's proposals for design options to address the issues relating to the Your Future, Your Super (YFYS) annual performance test as identified in the 2022 YFYS Review. An effective performance test to ensure accountability on investment performance and fees can help improve member outcomes. However, if the test is not effectively designed, there is a risk of unintended consequences that can hinder trustees' ability to act in members' long-term best financial interests, impose unnecessary compliance costs, and undermine member choice.

The design options proposed in the Consultation Paper do not adequately incorporate sustainability-related factors that trustees are already beginning to consider, especially in terms of pursuing sustainability outcomes and making asset allocation and stewardship decisions that enable them. We recommend that in order to ensure that further consideration of a new test does incorporate these factors, Treasury should develop:

- a principle to ensure that the long-term investment horizon of super funds and their duties in line with best financial interest to consider and pursue sustainability outcomes are recognized and protected;
- and/or a principle that also ensures that trustees are able to identify, implement and support the development of relevant benchmarks to take action to pursue sustainability outcomes in line with their duties.

The PRI does not support the retention of the current test. We also do not view the replacement of the test with another single-metric test as a step forward, as they each assess a narrow aspect of a fund's performance and do not enable the assessment of total portfolio performance. This situation, combined with the consequences of failing the test, is likely to disincentivize decision-making to improve member outcomes, including those related to environmental and social sustainability. However, a multi-metric metric test may be a viable alternative to consider, as a combination of such single metrics can complement each other to reduce the temptation of gaming the test, and lend greater flexibility to pursue investment approaches that can deviate from the conventional norms and benchmarks.

The PRI encourages Treasury to consider mechanisms to enable the use of an alternative index that would be designed to take into account the sustainability goals that are needed to meet long-term financial objectives. In considering such an approach, the Government may benefit from engaging a credible, independent third party to advise on the development and/or selection of appropriate sustainable benchmark indices. Relatedly, it should also consider approaches it can take to incorporate asset classes that are identified to play an integral role in addressing the Australian market's system-level risks, such as unlisted clean energy assets.

DETAILED RESPONSE

BACKGROUND: PENSION AND SUSTAINABILITY

BACKGROUND: COMPREHENSIVE POLICY REFORM NECESSARY FOR A SUSTAINABLE PENSION SYSTEM

Research carried out by the PRI in 2020 and 2021 on the Australian, United Kingdom, United States and Japanese pension systems found that there are policy, structural and market barriers to sustainability in these jurisdictions, which impact the ability of pension funds to incorporate ESG factors within their investment decisions and stewardship activities and to take action to pursue sustainability outcomes in keeping with their fiduciary duties.

Following this research, the PRI, the UNEP Finance Initiative and the Generation Foundation commissioned A Legal Framework for Impact, a report authored by Freshfields Bruckhaus Deringer and published in 2021. With a ground-breaking analysis of 11 jurisdictions around the world, the report considered whether the law permits or even requires investors to tackle sustainability challenges by setting and pursuing sustainability objectives. The report found that, under existing laws, pension funds are likely to have a legal obligation to consider investing for sustainability impact where this can help in pursuing their investment purpose and objectives. However, pension funds may face impediments to setting and pursuing positive sustainability objectives. With this in mind, this Legal Framework for Impact (LFI) briefing suggests a number of recommendations for policy makers to address these barriers, with an Australia-specific report to complement the global findings.

In 2023, the PRI carried out further industry research and practitioner interviews in Australia, the UK and the US to gather updated perspectives on the barriers to embedding sustainability in pension systems. Drawing on the conclusions of the PRI's earlier pension reports and the LFI study, this report summarises the findings from this research in 10 priorities that are necessary for a pension system to take sustainability considerations into account.[1]

Addressing the unintended limitations of the Your Future, Your Super (YFYS) annual performance test is an important step that needs to be taken towards ensuring that key actors in the Australian pension system are enabled and incentivized to build sustainable investment portfolios and ultimately help beneficiaries to become more informed about the sustainability objectives of their schemes. A more holistic and consistent approach that considers such broad priorities is necessary to ensure that the pension sector is equipped with comprehensive support and regulatory guidance.

[1] The PRI acknowledges that these 10 priorities are not exhaustive and further nuance and context is necessary when applying them to different markets and pension schemes.

THE UNINTENDED CONSEQUENCES OF THE YFYS PERFORMANCE TEST

The need for superannuation trustees to consider sustainability-related risks

Pension funds are long-term investors and their ability to generate long-term returns relies on the performance of the markets and economies in which they invest. Because sustainability factors such as climate change and biodiversity loss threaten the performance of the markets and economies on which they rely for financial returns, pension funds have a responsibility to consider whether sustainability-related risks, including those that are considered system-level risks, will inhibit their ability to protect long-term value and provide an adequate pension to their members or beneficiaries.[2] Accordingly, pension funds are increasingly seeking to mitigate these risks through their investment decisions and stewardship activities.

The PRI's policy analysis finds that legislative and regulatory frameworks should explicitly require superannuation funds to address such risks.[3] This may require superannuation funds to consider sustainability-related systemic risks, set related sustainability goals (including by reference to the achievement of global objectives such as the Paris Agreement goals and the UN Sustainability Development Goals), and pursue them through a combination of investment decisions, stewardship, and policy engagement.

Especially where it pertains to superannuation trustees, APRA has taken important steps through prudential guidance to clarify the imperative for them to consider sustainability risks. Investment governance guidance for super funds released in July 2023 includes a section on ESG investing and risk factors, noting that, in addition to managing ESG risks, super funds may incorporate "environmental or social impact related objectives, where it can demonstrate that pursuing such additional objectives is consistent with the outcomes the Registered Superannuation Entity licensee seeks to provide beneficiaries".[4] Similarly, guidance on climate change financial risk released in November 2021 noted that "APRA is of the view that climate risks can and should be managed within an institution's overall business strategy and risk appetite, and a board should be able to evidence its ongoing oversight of these risks."[5]

The current policies relating to the YFYS legislation pose potential barriers for trustees to act on these duties and leverage supporting policies

The PRI's position on the unintended consequences of the YFYS annual performance test remains consistent with the views outlined in our submission to the 2022 Review. The YFYS annual performance test likely impedes superannuation trustees in their consideration of measures to address these sustainability-related risks in various ways, with the key concerns outlined in the Consultation Paper (pages 7-8) all playing a role to a certain extent. This situation is causing confusion in the market as trustees are unable to reconcile between the duties and expectations casted upon them to address sustainability risks and also meet the requirements of the performance test.

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[2] Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), A Legal Framework for Impact: Sustainability impact in investor decision-making.
[3] PRI, (2022), A Legal Framework for Impact: Australia.
[4] APRA (2023), Prudential Practice Guide SPG 530 Investment Governance
[5] APRA (2021). CPG 229 Climate Change Financial Risks

This is importantly due to the fact that the duty for superannuation trustees to consider sustainability-related system-level risks and pursue sustainability outcomes where doing so can reasonably mitigate these risks is not recognized in the design of the test sufficiently. This is especially evident in the indices and asset classes listed in the current legislation[6], which are backward-looking indices that do not incorporate sustainability outcome goals, such as the Paris Agreement and Australia's climate and nature commitments. The covered asset classes and assumed indices mean that assessments against a reference portfolio based on the reported SAA (strategic asset allocation) penalize investments in new and emerging assets as "tracking error".

There is increasing research shedding light on the consequences of the performance test relating to strategies that incorporate sustainability outcomes. Research commissioned by Future Group and conducted by Mandala Partners found that performance test settings are disincentivising super funds from investing in assets that will enable Australia's energy transition and incentivising funds.[7] Similarly, research by Conexus Institute found that if trustees were to implement mainstream ESG strategies with a focus on sustainability and carbon transition activities, they would have to face an unsustainably high level of performance test tracking error, which increases the risk of a "false positive" YFYS test failure.[8]

[6] The Australian Government (2022). Superannuation Industry (Supervision) Regulations 1994. Subregulation 9AB.
[7] Mandala Partners (2024). Superannuation and climate change: Better Returns for a Better Climate
[8] The Conexus Institute (2022). Your Future, Your Super Performance Test: Constraint on ESG, Sustainability and Carbon Transition Activities

POSITIONS RELATING TO THE PROPOSED DESIGN OPTIONS

REFORM PRINCIPLES

The PRI welcomes the proposal by Treasury to establish design principles in the consideration of potential reform options. However, we note that while the design options presented in the Consultation Paper uphold these principles to a certain extent, we identify that concerns are likely to remain on the extent to which these options sufficiently incorporate the need for trustees to consider sustainability-related system-level risks and take necessary measures to address these risks.

We believe that this concerns the first principle on "improving member outcomes". As is noted in the Consultation Paper, this aims to be "consistent with the proposed objective of superannuation", which is "to preserve savings to deliver income for a dignified retirement, alongside government support, in an equitable and sustainable way". Per our response to the March 2023 consultation, however, we are concerned that the reference to sustainability here employs a simplified and narrow interpretation of the term, focusing on how the superannuation system can maintain stability in response to economic, social, and demographic changes. Despite the explanatory text of the consultation paper, the definition of sustainable does not recognise the superannuation system's reliance on a strong and resilient economy, and the legitimate role of superannuation in delivering income in a manner that proactively supports and does not undermine the stability of the economy as well as the environmental and social systems upon which the economy relies.

This continues to be a concern that Treasury needs to address. As identified in detailed legal analysis published by the PRI and other partners, superannuation trustees' duty to act in their beneficiaries' best financial interests requires them to maintain and improve long-term financial performance by addressing both current and anticipated system-level risks.[9] Additionally, evidence increasingly shows that individual investors want their investments to contribute to positive or reduce negative sustainability outcomes in the real world.[10] Research by the Responsible Investment Association Australasia, for example, shows that 80% of Australians expect their investments to have a positive impact on the world.[11] We have also seen guidance from APRA recently highlight that in addition to managing ESG risks, super funds may incorporate environmental and social impact related objectives where doing so is consistent with the outcomes they seek to provide beneficiaries.[12]

On a broader scale, we also observe that there are broad policy trends such as those underpinned by the national sustainable finance strategy that aim to establish national-level sustainability outcome goals and implement financial policy measures that enable private capital to support these goals. In this process, pension-related policies are also facing a need to ensure that investors that aim to leverage the outputs of these policies, such as climate-related financial disclosures, are able to do so.

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[9] Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), A Legal Framework for Impact: Sustainability impact in investor decision-making, PRI (2022), A Legal Framework for Impact: Australia.
[10] Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), A Legal Framework for Impact: Sustainability impact in investor decision-making (p.56-60); Fidelity International (2022). Fidelity survey: APAC investors' strong interest in sustainable investing continues, with a confidence challenge still to tackle.
[11] Responsible Investment Association Australasia (2022), From Values to Riches 2024: Charting consumer demand for responsible investing in Australia
[12] APRA (2023), Prudential Practice Guide SPG 530 Investment Governance

Market practices and policies are increasingly being conscious of the need to integrate sustainability-related system-level risks into the fundamental design of policies. The proposed principles are not sufficiently cognizant of this understanding and will risk inviting the same unintended consequences as before.

As such, we recommend that Treasury consider the 10 principles we present in our aforementioned report, [Progress and priorities: reviewing sustainability in key pension systems](). We particularly note that in line with Priority 1, a principle should be introduced to ensure that the long-term investment horizon of super funds and their duties in line with best financial interest to consider and pursue sustainability outcomes are recognized and protected. And in line with Priority 9, a principle that also ensures that trustees are able to move beyond traditional pension fund investment strategies and identify, implement and support the development of appropriate benchmarks to take action to pursue sustainability outcomes in keeping with their duties.

DESIGN OPTIONS

The current test and alternative single-metric tests (Q2, Q9 and Q12)

We do not believe that the current model of assessing the implementation of a strategy, as opposed to assessing the choice of strategy itself, serves effectively the current framework. Considering and pursuing sustainability outcomes to address system-level risks with portfolio-level implications requires new investment approaches. A test based on the implementation of an SAA risks being too rigid for investors to consider such investments that are prone to increasing tracking error, which importantly makes it difficult to invest in opportunities that are new and emerging.

Alternative single-metric tests are likely to face similar issues to the current test if they are implemented as single metric tests, given that each test similarly compares to a benchmark. Largely, given the exposure of the existing market to fossil fuels, the same predicaments explored above will be repeated as the current test, and will not uphold the principle of a lasting test either if the market needs to revisit the test design due to the inflexibility caused.

A multi-metric framework (Q15, Q21)

The PRI supports the consideration of a multi-metric framework, to an extent that enables the incorporation of sustainability-related risks and opportunities. The structure of a multi-metric test, in theory, would allow for a more holistic evaluation of performance, either as an option akin to Option 3a that leverages the APRA heatmaps (or a revised version of it) or by route of an option similar to Option 3b that incorporates targeted metrics. There are a number of solutions presented by our peers in the responsible investment space that present improvements to these multi-metric frameworks to better incorporate sustainability factors.

On Option 3a, we would importantly note that the APRA heatmap in its current form should especially be avoided from being incorporated into the performance test. The heatmaps do not consider the underlying investment processes, such as active management, tilting or other approaches that may be applied to shape sustainability outcomes and whose results may not be apparent over the short term analysed by APRA. They importantly do not address the rigidity associated with testing against the SAA and do not offer sufficient consideration of system-level issues and long-term risks as opposed to short-term performance.

In terms of Option 3b, if the selection of metrics and the implementation of the tests are appropriately done, this can contribute to the sophistication of the test and address key concerns relating to the current test. It could provide greater flexibility for trustees to consider and pursue sustainability-related outcomes while also being incentivized to maintain competitive performance. That said, the selection of metrics as the Consultation Paper notes is a contested area that will require further consideration to ensure its compatibility with responsible investment practices.

Alternative benchmarks and additional asset classes (Q5)

In terms of establishing the comparative benchmarks across these single-metric tests, we encourage the Government to consider mechanisms to enable the use of an alternative index that is modelled based on sustainability goals required to ensure long-term financial return objectives. In considering such an approach, the Government may benefit from engaging a credible, independent third party to advise on the development and/or selection of appropriate sustainable benchmark indices. Certification mechanisms and labelling standards will no doubt play an important role in this space, further pointing to the need for the Government to take a coordinated and whole-of-government approach to addressing these issues.

In a similar vein, the current test or any improved test design can stand to benefit from incorporating additional asset classes that are identified to play an integral role in addressing the Australian market's system-level risks. From a climate change perspective, for example, a domestic, unlisted clean energy infrastructure asset class can be added to remove barriers the current test presents to investing in this asset class. Including emerging assets where they help addressing national system-level risks could also be used for other asset classes that are likely to surface as Australia's economy transitions to a low carbon economy and new technologies and opportunities become clearer. Other priorities for the Government could also replicate this approach as the development of the taxonomy sheds light on financing needs aligned with necessary sustainability outcomes.

The PRI has experience of contributing to public policy on sustainable finance and responsible investment across multiple markets and stands ready to support the work of the Treasury further to support the revision of the YFYS annual performance test.

Please send any questions or comments to policy@unpri.org.

More information on www.unpri.org