

FUTURE GROUP

Superannuation Efficiency and Performance Unit
Retirement, Advice and Investment Division
The Treasury
Langton Crescent
PARKES ACT 2600
(via email: YFYS@treasury.gov.au)

19 April 2024

Annual Superannuation Performance Test – Design Options

Dear Treasury,

Future Group supports the existence of a performance test as a measure to help safeguard the retirement savings of Australians. However, the test's design does not currently consider the complexity of investing in a world impacted by climate change. Our feedback prioritises pragmatic refinements that can be implemented relatively quickly to best serve the long term financial future of superannuation members.

Our submission focuses on the opportunity to address the specific challenge of removing any barriers that the performance test has inadvertently created for superannuation funds to invest in assets that have the capacity to provide strong risk adjusted returns but which may not be correlated with the current benchmarks. Of particular concern is the fact that assets that are not correlated with the current benchmarks include investments that can support our nation's clean energy transition while being in the long term financial interests of members.

Background: carbon emissions and superannuation

Superannuation funds have been the beneficiaries of at least 30 years of economic growth, during which man-made greenhouse gas emissions were released in unprecedented volumes globally. About half of the 1.5 trillion tonnes of CO₂ emitted since the start of the Industrial Revolution occurred post-1990. As part of funds' duty to invest contributions in the best financial interests of their members, funds have, one way or another, been financing or benefiting from the activities that have contributed to climate change.

As the Australian government, and governments around the world, meet net zero commitments, economic growth will be necessarily decoupled from greenhouse gas emissions. This bifurcation may have profound impacts on investment returns.

The Australian Government tracks the nation's individual greenhouse gases emissions, as well as CO₂ equivalent through the National Greenhouse Gas Inventory. According to the June 2023 update, Australia emitted 465.2 million tonnes of CO₂ equivalent, which marked a 0.8% increase as compared to June 2022.

Energy production is the largest contributor to Australia's carbon emissions. This is followed by transport, agriculture, and industrial processes. Specifically:

- energy (burning fossil fuels to produce electricity) contributed 32.6% of the total emissions
- stationary energy (including manufacturing, mining, residential and commercial fuel use) 22.3%
- transport 21.1%
- agriculture 17.7%
- fugitive emissions 10.2%
- industrial processes 7%

- waste 2.9%

The science is clear: a massive near-term effort to reduce emissions is needed, and the Australian Government has agreed to be a part of that effort by legislating a path to reach net zero by 2050.¹ With carbon emissions making up more than 420 parts per million (ppm) of the Earth's atmosphere today, we are already very close to the dangerous level of 450 ppm. We have no time to waste.

The United Nations Intergovernmental Panel on Climate Change (IPCC) has reported² that financial flows directed at decarbonisation globally are a factor of three to six times lower than levels needed by 2030 to limit warming to below 2°C. The IPCC observed there is sufficient global capital and liquidity to close the investment gaps. However, a stronger alignment of public sector finance and policy is required to unlock this capital. To invest in the solutions to climate change, investors - including superannuation funds - need clear signalling from governments or, at the very least, the removal of disincentives.

The problem with the performance test and Australia's energy transition plan

In today's environment, a superannuation fund investing in renewable energy assets is penalised under the performance test as there is no legislated index against which such an investment can be properly measured.

The Capacity Investment Scheme, under which the government will de-risk investment in renewables, seems directly targeted at superannuation funds and other patient investors.³ The performance test, however, currently points in the opposite direction, disincentivising funds from making those very investments despite their potential to deliver attractive risk-adjusted returns.

Compounding the issue, the current performance test incentivises investment in fossil fuels due to the prevalence of such assets in the legislated indices, which is not in the long-term financial interests of superannuation members or the planet.

Last year, Future Group commissioned Mandala Partners to analyse the economic impacts of the current performance test settings on long term superannuation fund returns and Australia's economy, taking into account climate change and the energy transition. The findings in Mandala Partners' report⁴ were profound. The research found that the performance test settings were disincentivising superannuation funds from investing in assets that would enable Australia's energy transition and were instead incentivising funds to invest in high carbon assets. The research found the current performance test settings will have the following impact:

- the potential for superannuation fund members to miss out on a forecasted 15% and 28% higher return over 10 and 20 years, respectively, if funds fail to respond as markets begin to price in climate risk;
- missing the opportunity to reduce carbon emissions by 36 million tonnes over 30 years;
- missing the opportunity to increase real GDP by \$170 billion in 10 years;
- missing the opportunity to add 620,000 new green jobs over 10 years;
- missing the opportunity reduce inflation by 7% over 10 years; and
- the Government increasing net debt by 13%.

Mandala's research indicates that investments in renewable energy and other climate-saving activities are in the best financial interests of members over the long term. Failure to enable superannuation funds to make these investments

¹ <https://www.dcceew.gov.au/climate-change/emissions-reduction/net-zero>

² <https://www.ipcc.ch/2022/04/04/ipcc-ar6-wgiii-pressrelease/>

³ <https://www.dcceew.gov.au/energy/renewable/capacity-investment-scheme>

⁴ <https://mandalapartners.com/reports/super-and-climate-change>

would not only be a regrettable legacy to leave to the next generation, but from a Registrable Superannuation Entity (RSE) licensee perspective, creates significant tension in attempting to discharge the best financial interests duty.

How current policy holds back investment in the energy transition

The current benchmarks in the performance test have a constraining impact on investment activities that relate decarbonisation. These constraints are prescribed in subregulation 9AB.17(7) of the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations), where backward-looking indices that are out of alignment with Paris Agreement and Australian emissions reduction targets, are laid out.

Therefore, superannuation funds investing in assets that align to, or support, Paris and Australian emissions reduction targets do so at the risk of 'performance test tracking error'. This exposes the fund to the risk of failing the test. If a fund seeks to engage in these activities outside the listed investments environment (e.g. via direct infrastructure investment or private equity), the risk of tracking error is even greater given that many social and environmental infrastructure assets have a different risk and return profile to the assets that make up the benchmark. For example, some of these infrastructure investments might have significantly lower risks than economically exposed infrastructure assets due to having fully contracted and sometimes government-supported returns. While on a risk-adjusted basis, and as part of a diversified portfolio, these public-private partnerships may be in the best interest of members, trustees are disincentivised from diverging from assets that more closely align with the performance test benchmarks.

Despite superannuation-specific regulatory requirements to consider the financial risks of climate change, the current performance test benchmarks produce conflicting priorities for funds. RSE licensees have an obligation to manage the financial risks of climate change risks under 'CPG 229 - Climate Change Financial Risk', yet are incentivised via the performance test to invest in heavy emitting assets to reduce their tracking error.

This concerning malalignment is compounded by the efforts of those funds who are transitioning portfolios to align with a net zero by 2050 commitment and with interim emissions reduction goals.

Alignment of public policy is critical to allowing RSE licensees to focus on delivering the best risk-adjusted returns for members.

History of the YFYS performance test

The Morrison Government's YFYS reform package was announced in the 2020-21 Budget. The *Treasury Laws Amendment (Your Future, Your Super) Act 2021* introduced the performance test for MySuper products (and other measures) with effect from 1 July 2021. The typical consultation process was held prior to the legislation being finalised. Since that time, there have been two further policy consultations conducted by Treasury (including this one) on the YFYS regime.

The first consultation ran from 7 September to 14 October 2022 and, in relation to the performance test, Treasury sought stakeholder input 'on the test methodology, the consequences of failure and product coverage'. Treasury received 75 submissions in response to the consultation paper and held discussions with nearly 100 stakeholders including:

- 5 roundtables;
- 23 bilateral meetings; and
- 3 technical working group meetings.

In addition, there was a Bill drafted and consulted upon in 2022 to accommodate so-called 'faith-based' investing into the performance test, which was not ultimately proceeded with.

In June 2023 as a result of the first review, the Assistant Treasurer Stephen Jones announced a range of changes to the performance test. The changes included that:

- the minimum testing period was to be increased in line with the increase of the longer-term investment testing 'lookback' period;
- key benchmarks were to be calibrated to ensure that funds were not unintentionally discouraged from investing in certain assets; and
- in assessing the RAFF (representative administration fee) for trustee-directed products (TDPs), platform and non-platform products were to be benchmarked against a median fee relevant to this category.

The point of raising the history of the performance test is to highlight the fact that it has given rise to many technical issues, notwithstanding its overall efficacy. In many respects, the performance test is not suited to being in delegated legislation at all. It is highly complex and relates to matters, such as commercially produced asset class indices, investment products and market developments, that are subject to constant change. The solution is addressed in the next section.

Design recommendation 1: Amalgamating the performance test into the APRA heatmaps (modified Design Option 3a)

Future Group's preferred design option is a modification of Design Option 3a of the Treasury Consultation Paper. We propose that the existing performance test be amalgamated into APRA's heatmap framework. That is, there would be a 10-year performance test based on the benchmarks currently utilised and including the existing approach to the incorporation of fees that is contained within the heatmap. This approach would mean the existing performance test would remain as is and broadly unchanged. All relevant products would be measured against this component of the heatmaps in the same way as under the current performance test.

One immediate outcome would be the simplification of the current superannuation fund assessment framework, which would also reduce the administrative burden on APRA and the industry.

Where we propose a more substantial change is in the situation where a product fails the performance test. In this case, APRA should then assess the product against the other elements of the heatmap, meaning the existing infrastructure of the multi-metric heatmap would then be applied to provide a more detailed appraisal on the nature of the product's failure. Incorporating a multi-metric assessment for products that fail the 10-year performance test would significantly mitigate against the issues of operating a single metric performance test that are outlined in the Consultation Paper.

The heatmap includes a three and five-year investment performance assessment to enable the trend of a product's return profile to be understood, as well as fee levels and on-going viability through member growth, cash flow and rollover performance. These aspects provide a much more comprehensive assessment of a product's performance. While there are other or additional metrics that could further enhance the effectiveness of the heatmap, its current makeup is sufficient to be applied today.

Where a product also produces concerning outcomes on these other metrics, APRA can then classify a product to have failed the performance test and existing consequences would apply. However, for a product that demonstrated positive outcomes on the other metrics e.g. strong investment performance in the most recent three years and positive growth in all three viability metrics (member growth, cash flows and rollovers), APRA could determine that it did not fail the performance test. Importantly, APRA has already established a quantitative assessment of each of the heatmap metrics through its colour coded system. Therefore, all that would be required to formalise a framework for the heatmap assessment is the creation of a rule set (e.g. the number of reds, ambers etc).

Design recommendation 2: Additional asset class

Future Group proposes that a new benchmark be introduced to the performance test. A domestic, unlisted clean energy infrastructure asset class benchmark is needed to remove the current unintentional disincentive to invest in this

asset class. The implication of these assets not currently being appropriately reflected in the current list of 'assumed indices' in Part 9AB of the SIS Regulations is that funds will be exposed to tracking error when allocating capital to such assets, despite them being critical to Australia's energy transition and having the ability to offer strong risk-adjusted returns.

For context, the total superannuation sector investment allocation to the infrastructure asset class was \$207bn⁵ at December 2023. If asset allocations remain in the same proportions, this amount could grow to over \$840bn by 2040.⁶ Very little of this capital is currently invested in renewable energy and decarbonisation infrastructure, which are fundamental to Australia's energy transition. Without any changes to current investment allocations, the superannuation sector is very well placed to invest in infrastructure but needs relevant benchmarks in the performance test to properly represent performance comparisons.

Future Group has coordinated some initial work with the Clean Energy Finance Corporation (CEFC) and MSCI to establish that such a benchmark could be created. Through this work, we identified approximately \$1.7bn of assets across three pooled funds that comprise purely renewable energy infrastructure assets. More assets are needed to comprise a robust index and they could be identified if the Government were to indicate that such a benchmark is to be introduced. This would create policy certainty such that relevant asset owners would be willing to share underlying performance data with the benchmark provider.

Importantly, such an asset class does not yet have 10 years of performance history. Five to seven years of history is generally the longest timeframe available to use in a performance test setting. However, we view this predicament as an opportunity for the Government. For the missing years of performance history, proxy returns could be used - for instance the 10 year Australian bond rate, plus an appropriate margin. This should create an incentive for funds to allocate capital to this asset class due to the tracking error benefit that should be realisable from such an approach.

This alteration to the performance test represents a cost-free way for the Government to incentivise the allocation of capital to clean energy infrastructure assets in Australia (in line with a range of its policies, including the Capacity Investment Scheme). As the missing years of performance history roll off, actual returns would replace them, meaning the incentive would have a natural time limit.

This structure could also be used for other asset classes that are likely to emerge as Australia's economy transitions to a low carbon economy and new technologies and opportunities emerge. Other priorities for the Government could also replicate this approach with a pertinent example being investment by superannuation funds in social housing.

Crucially, RSE licensees would still need to balance overall return objectives and the best financial interests of their members when contemplating allocating capital to such an asset class. This modification would not require funds to invest in this asset class – funds could choose to do so if it met their overall return objectives. Our investment strategy has demonstrated to date that good returns are possible from investing in clean energy assets today, alongside not investing directly in fossil fuel companies.

Design recommendation 3: Alternative benchmarks for responsible or ethical investing

Future Group proposes that where a product fails the 10-year performance test, in addition to taking into account the information gleaned from the heatmap, APRA should also use alternative benchmarks for equities (domestic and international) and fixed income for certain products. These alternative benchmarks would be applied to products with specific requirements to invest in line with responsible or ethical investing mandates and where these products have been marketed as such.

⁵ <https://www.apra.gov.au/quarterly-superannuation-industry-publication>

⁶ Utilising ASFA's industry growth forecasts: <https://www.superannuation.asn.au/resources/super-stats/>

The simplest way for APRA to classify such products as being eligible for this approach would be those that have obtained Responsible Investment Association of Australasia (RIAA) certification, which is a market-accepted methodology to identify responsible or ethical superannuation products. Certification criteria includes having formal responsible investment strategies that are auditable. In conjunction with ASIC's proactive enforcement against greenwashing, there is now a population of credible products that are better suited to being assessed against alternative benchmarks than those in the current performance test.

We are agnostic on which specific index should be used in these cases but note low carbon and/or Paris-aligned benchmarks exist for these asset classes and are provided by the major index providers. Many of these are low-carbon benchmarks that much more closely reflect the investment strategies of such products. Such a dimension would enable such products to be much better assessed by APRA in terms of performance. From an implementation perspective, these benchmarks would replace the existing equities and fixed income benchmarks after which APRA would conduct another calculation of the performance test.

Some examples of such indexes with ten years of performance history include:

- MSCI Australia IMI Custom ESG Leaders Index (domestic equities)
- MSCI Australia IMI Select SRI Screened Index (domestic equities)
- S&P Dow Jones ASX 300 Carbon Efficient Index (domestic equities)
- S&P Developed Ex-Australia LargeMidCap Carbon Control Index (international equities)
- MSCI World Climate Paris Aligned Index (international equities)
- S&P Green Bond Index (fixed income)
- FTSE Global Green Impact Bond Index (fixed income)

Design recommendation 4: Ongoing oversight and governance of assumed indices

Another area requiring attention is ongoing oversight of the efficacy and coverage of the indices used in the performance test. Future Group's 14 October 2022 submission to the previous YFYS Review consultation contained a proposal to establish a Performance Test Governance Group (PTGG) to conduct such an oversight role. The PTGG should be composed of industry experts, asset class experts, APRA and Treasury. This body could look forward to ensure that emerging asset classes are being proactively catered for by adding asset classes to the performance test as the need arises. As Australia transitions to a low carbon economy, new asset classes are likely to emerge. A dynamic population of asset classes in the performance test would help superannuation funds invest in these opportunities in the long term best financial interests of their members.

Key consultation questions

Future Group has provided answers to seven questions. Responses are matched against corresponding numbers in the March 2024 Treasury consultation paper entitled: 'Annual Superannuation Performance Test- design options'. The answers below are summaries to further detail provided earlier in this submission.

4. What asset classes do you consider require better coverage in the test?

Including domestic, unlisted clean energy infrastructure as an asset class in the remit of the performance test would encourage and enable superannuation funds to invest in assets that facilitate the energy transition. Such a measure would be in line with the Government's Net Zero pathway. In addition, the performance test would benefit from an ability to include emerging asset classes as Australia transitions to a low carbon economy.

5. Do you consider additional indices covering additional asset classes should be added to the test? If so, please provide the following details for each of your recommendations:

a. Description of asset class

The most urgent asset class for the performance test to consider, in light of climate change, is domestic, unlisted clean energy infrastructure assets.

b. Name of recommended index covering the above asset class, including the length of time data is available on the index

A new index for domestic, unlisted clean energy infrastructure assets needs to be established, and initial work has already been undertaken. Future Group has coordinated initial work with the Clean Energy Finance Corporation (CEFC) and MSCI to establish that such a benchmark could be created. Through this work, we identified approximately \$1.7bn of assets across three pooled funds that comprise purely renewable energy infrastructure assets. Importantly, the asset class performance history will be less than 10 years, which will be the case for every new emerging asset class. However, time-capped proxy returns can be utilised to address this issue, which also enables limited incentive structures to be incorporated. See page 4 and 5 for more details.

6. How should the test cater for new asset classes in the future?

APRA should be empowered to use its rule-making power to include new asset classes in the future by following its normal process of consultation and exposure of proposed new inclusions, just as it does in making prudential standards. With the performance test rolled into the APRA heatmaps regime, this becomes a much more enduring and workable arrangement.

In addition, a Performance Test Governance Group should be established to oversee the ongoing efficacy of the benchmarks, including introducing new asset classes. See page 6 for more information.

8. Would retaining the current framework but moving to a simpler structure, such as a simple-reference portfolio of only bonds and equities, address some of the concerns with the current test?

Retaining the current framework but moving to a simpler structure, such as a simple-reference portfolio of only bonds and equities, would not go far enough to address the concerns Future Group has about the viability and unintended consequences of the performance test. This solution would, in effect, be heading in the wrong direction. Given the urgent need to decarbonise the economy and the amount of capital in the superannuation system (circa \$3.7 trillion), it is in the interest of Australia's economic prosperity and the Government's stated ambitions on climate action to leave no impediment in the way of superannuation funds making renewable energy investments that are in the long term best financial interests of their members. A 24-year-old female joining a superannuation fund this year is more than likely to still be alive in the 2090s – way beyond the 2050 Paris target. It will be critical to her financial future that Australia decarbonises our economy in line with our Paris commitments. The actions her fund takes to adjust its investment strategy as this transition occurs will be one of the most meaningful determinants of her superannuation balance at retirement.

15. Would greater alignment to the APRA heatmaps improve the sophistication of the test?

Greater alignment with the APRA heatmaps would improve the sophistication of the test. Future Group believes that the performance test should be rolled into the heatmaps regime. Such a change would incorporate existing infrastructure to enable a multi-dimensional assessment of products that fail the initial performance test. Further details are provided on page 4 of this submission.

16. Would it reduce incentives to benchmark hug and improve member outcomes?

Greater alignment with the APRA heatmaps would reduce incentives to benchmark hug and improve member outcomes due to the incorporation of a multi-metric assessment process and inclusion of alternative benchmarks for RIAA-certified products, which we describe on page 4 of this submission.

18. Should the test capture all the metrics in the heatmap? If not, what metrics.

For ease of implementation, all the metrics in the APRA Heatmap should be utilised in the assessment for products that fail the 10-year performance test. APRA's current colour-coded assessment could be used to weight metric outcomes. See page 4 for more details.

Summary of recommendations

- **Amalgamating the performance test into the APRA heatmaps (modified Design Option 3a)**

The existing performance test to be amalgamated into APRA's heatmap framework. This would be a 10-year performance test based on the benchmarks currently utilised and including the existing approach to the incorporation of fees that is contained within the heatmap. This approach would mean the existing performance test would remain as is and broadly unchanged. All relevant products would be measured against this component of the heatmaps in the same way as under the current performance test. One immediate outcome would be the simplification of the current superannuation fund assessment framework, which would also reduce the administrative burden on APRA and the industry. Where a product fails the 10-year performance test, APRA is to then assess the multi-metric information gleaned from the Heatmap, using its existing colour-coded rating system. Based on this broader assessment, if APRA concludes that a product still fails the performance test, the existing consequences are to apply.

- **Additional asset class**

A domestic, unlisted clean energy infrastructure asset class is needed to remove the current unintentional disincentive to invest in this asset class. The implication of these assets not currently being appropriately reflected in the current list of 'assumed indices' in Part 9AB of the SIS Regulations is that funds will be exposed to tracking error when allocating capital to such assets, despite them being critical to Australia's energy transition and having the ability to offer strong risk-adjusted returns.

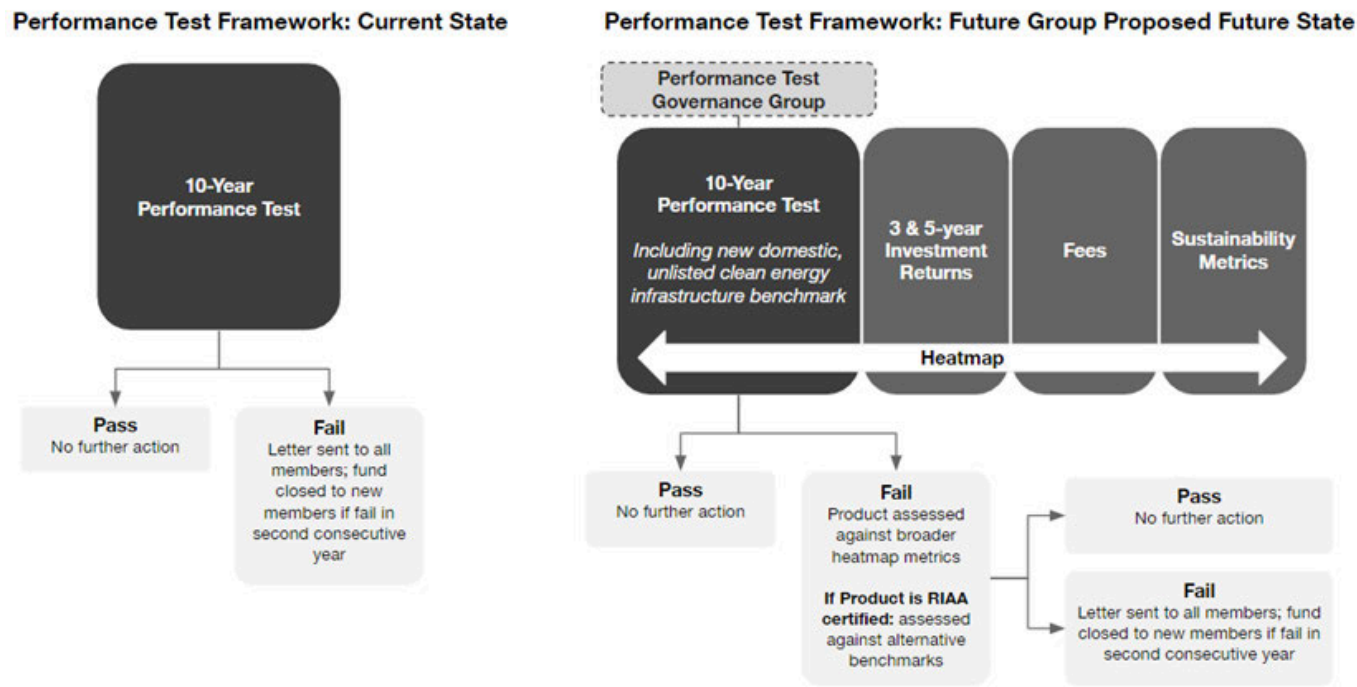
- **Alternative benchmarks**

APRA should also use alternative benchmarks for equities (domestic and international) and fixed income for RIAA-certified products when assessing investment return performance if they fail the initial 10-year performance test. These alternative benchmarks better assess investment performance for responsible and ethical products. Based on this broader assessment, if APRA concludes that a product still fails the performance test, the existing consequences are to apply.

- **Ongoing oversight and governance of assumed indices**

The establishment of a Performance Test Governance Group (PTGG) to conduct such an oversight role of the assumed indices. The PTGG should be composed of industry experts, asset class experts, APRA and Treasury. This body could look forward to ensuring that emerging asset classes are being proactively catered for by adding asset classes to the performance test as the need arises.

Schematic of proposed changes



About Future Group

Future Group is a mission-driven, superannuation-focused ethical investment business serving over 385,000 members and \$15 billion in funds under management and advice.

Future Group’s mission is to create a future worth retiring into. Our investment philosophy is anchored in our purpose of driving industry wide change by providing authentic, ethical investment products. Our vision is to see all of Australia’s retirement savings invested to drive positive social and environmental impacts. Core to our investment philosophy is the belief that we have a responsibility to invest sustainably, and that doing so protects our members’ futures - both financially and physically. This suits the long-term, multi-decade investment horizon of our members.

Future Group has recently established a Carbon Advisory Board, which is an advisory forum that engages with management in relation to our net zero efforts. The main responsibilities of the Carbon Advisory Board are to:

- advise on Future Group’s approach to managing climate-related risks and opportunities, including the development and implementation of its net zero strategy;
- advise on sustainable finance and climate risk research developments;
- engage with key stakeholders across Government, regulators, academia and industry to share insights and help influence collective progress towards net zero; and
- assess Future Group’s progress towards interim targets.

Given the points raised in our submission on the implications of the current settings of the performance test, our Carbon Advisory Board has been heavily engaged in determining how best the test can be adjusted to no longer obstruct credible and timely net zero targets to be set by superannuation funds.

Please contact Fahmi Hosain - Chief Risk Officer and Head of Government Relations - at [redacted] or [redacted] if you have any questions on our submission.

Yours sincerely



Simon Sheikh
Chief Executive Officer
Future Group

Yours sincerely



Jeremy Cooper
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Future Group Carbon Advisory Board

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