

14 October 2022

The Treasury
Email: YFYS@treasury.gov.au

Dear Sir/Madam

REVIEW OF YOUR FUTURE, YOUR SUPER MEASURES

On behalf of the Australian Council of Superannuation Investors (ACSI), thank you for the opportunity to make a submission in respect of Your Future, Your Super measures.

About ACSI

Established in 2001, ACSI exists to provide a strong voice on financially material environmental, social and governance (ESG) issues. Our members include 26 Australian and international asset owners and institutional investors with over \$1 trillion in funds under management.

Through research, engagement, advocacy and voting recommendations, ACSI supports members in exercising active ownership to strengthen investment outcomes. Active ownership allows institutional investors to enhance the long-term value of retirement savings entrusted to them to manage. ACSI members can achieve financial outcomes for their beneficiaries through genuine and permanent improvements to the environment, social and governance (ESG) practices of the companies in which they invest. Our submission focuses on areas relevant to our focus on ESG and active ownership: the Performance Test and the Best Financial Interests duty.

Summary of ACSI position on Your Future, Your Super review

ACSI notes that the Your Future, Your Super (YFYS) measures were originally intended to improve accountability and transparency of superannuation fund activities.¹ ACSI strongly supports the goal of accountability and transparency. However, the test's flawed design has resulted in unintended consequences. ACSI recommends that the test is redesigned to reflect longer term investment horizons.

We have specific comments on the performance test below.

I trust our comments are of assistance. Please contact me or Kate Griffiths (kgriffiths@acsi.org.au), should you require any further information.

Yours faithfully



Louise Davidson AM
Chief Executive Officer
Australian Council of Superannuation Investors

¹ Cited in the background materials provided by the Government to explain the Your Future, Your Super package, https://treasury.gov.au/sites/default/files/2020-10/p2020-super_0.pdf, p25.

The Performance Test

The Consultation Paper notes that the objectives of the performance test are, 'to protect members from underperformance by holding trustees accountable for the investment performance they deliver to members and encouraging trustees to reduce fees.'² ACSI supports these objectives. It is important to identify persistent underperformance in a compulsory superannuation environment. There is also strong support for a performance test within the industry.³ ACSI recognises that investment performance and appropriate management of risk is integral to delivering returns to beneficiaries.

At the same time, there is agreement that the design of the performance test must be improved. A key concern is that performance test judges the implementation of an investment strategy rather than the investment strategy itself.⁴

The structure of the Performance Test risks dis-incentivising trustees from focus on longer-term issues that may affect investment performance, in particular where that focus may result in a shorter term deviation from benchmark returns. The test therefore effectively ignores the risk context for investment, making the test less accurate. For example, many investors take environmental, social and governance (ESG) risks, into account across their investment strategies (whether or not the product is specifically considered a sustainable option or similar) because they are financially material over the long-term. The nature of ESG risks, such as climate change, are systemic, systematic and long-term, which does not align with a performance test structured to measure the past seven or eight years.

The implementation of the performance test has had some unintended negative outcomes. Research has found that superannuation funds are shortening their investment horizons in response to the performance test.⁵ This suggests that trustees may find themselves in situations where they are required to choose between managing the performance test or members' best financial interests over the long-term. Many funds believe that the constraints placed by the performance test could result in lower returns for members.⁶ In addition, it is unclear that the performance test has accurately identified persistent underperformance. Research has found that while some of the funds that failed the test were unarguably underperforming, others failed due to protection strategies put in place to protect their older members or because of historical underperformance that outweighed more recent improvements.⁷

Issues with performance test design

A range of organizations, industry bodies and experts have highlighted multiple concerns with the design of the performance test. Identified weaknesses include:

- **Short investment horizons.** The design of the test, given its seven-to-eight-year timeframe, encourages a short-term investment focus. This conflicts with the long-term nature of superannuation investments. Consequently, the test encourages investment decisions that are aimed at passing the benchmark rather than the long-term financial outcomes of members. The focus on short-term investment horizons also potentially conflicts with APRA guidance that requires recognition of both short-term and long-term risks and opportunities.
- **Ignores risk.** The test does not take the risk associated with investment decisions into account, only measuring the raw performance of the fund. This means that funds may be pursuing an investment

² The Treasury. Your Future, Your Super Review. Consultation Paper, 7 September 2022, p.4, [Your Future, Your Super Measures Review \(treasury.gov.au\)](https://www.treasury.gov.au/your-future-your-super-review)

³ Conexus Institute, July 2022, *Assessing the impact of YFYS through interviews with CIOs of funds with performance 'buffer'*, p.1, <https://theconexusinstitute.org.au/wp-content/uploads/2022/07/Final-survey-paper-20220726-Conexus-IM-Final.pdf>

⁴ Frontier Economics, September 2021, *Super Performance Test*, p.3, <https://www.frontieradvisors.com.au/wp-content/uploads/2021/09/YFYS-performance-test.pdf>

⁵ Conexus Institute, July 2022, *Assessing the impact of YFYS through interviews with CIOs of funds with performance 'buffer'*, p.1, <https://theconexusinstitute.org.au/wp-content/uploads/2022/07/Final-survey-paper-20220726-Conexus-IM-Final.pdf>

⁶ Conexus Institute, July 2022, *Assessing the impact of YFYS through interviews with CIOs of funds with performance 'buffer'*, p.6, <https://theconexusinstitute.org.au/wp-content/uploads/2022/07/Final-survey-paper-20220726-Conexus-IM-Final.pdf>

⁷ Chant West, November 2021, *YFYS Performance Test: Good Intentions Marred by Collateral Damage*, <https://www.chantwest.com.au/resources/yfys-performance-test-good-intentions-marred-by-collateral-damage/>

strategy appropriate for their members, such as a conservative risk approach for older members, that delivers good outcomes when considering the risk context, but still fails the test.⁸

- **Ignores strategy underpinning investment decisions.** The performance test does not recognise that investment decisions based on their members' active choices, such as a sustainable investing option in a superannuation product. This lack of nuance may result in products failing the performance test while delivering on their members' investment choices. For example, a Socially Responsible Investing (SRI) fund designed to avoid fossil fuels such as coal may be considered to have delivered poor financial outcomes during a shorter-term rally in energy and materials prices, but reflects both the member's preference as well as views on the sustainability of the returns provided by the industry over the longer-term.⁹
- **Backwards looking.** The performance test only considers past performance within the seven-to-eight-year timeframe. As noted by ASIC, past performance is not a strong or reliable indicator of future performance.¹⁰ In addition, the test does not differentiate between historical underperformance and persistent underperformance. The fact that previous underperformance might have been attributable to a different investment team and/or investment strategy is not considered. Consequently, funds that may have had one or two years of poor performance that has since been rectified will be seen as the same as funds with persistent underperformance.¹¹

Principles to underpin a revised performance test

The range of issues identified with the current test suggests that the performance test should be redesigned. ACSI has identified several principles that could be used to underpin a performance test that meets the objectives of identifying persistent underperformance.

ACSI recommends incorporating the following principles in any redesign of the performance test:

- **Long term financial focus.** Design the test within the overall goal of maximizing members' financial net returns over the long-term. The performance test should recognise that investors need to manage their portfolios taking into account both significant risks, as well as opportunities, that may materialise over the long-term, including from the necessary transition into a low carbon economy.
- **Consider risk.** The test should incorporate an assessment of the risk context, such as whether the product's members are primarily in older age groups, will allow a more accurate assessment of financial performance. As noted above, ESG risks are taken into account across investments in recognition of the material financial risk they can represent. Incorporating the risk context would ensure a more accurate Performance Test.
- **Additional measures.** In order to provide a more accurate performance measurement, indicators that reflect the underlying design, and not just the implementation, of the investment strategy should be included in the test methodology. This should include a recognition of individual investment strategies to ensure that the benchmark is comparing like with like.
- **Align with regulator guidance.** At present there are inconsistencies with the demands of the performance test and other APRA guidance. For example, APRA's Prudential Practice Guide CPG 229 Climate Change Financial Risks (CPG 229) advises institutions to identify and monitor risks of climate change on business models. Part of this guidance advises that assessing climate change risks and opportunities requires both a short-term and long-term view.¹² The effect of long-term risk assessments on investment allocation is ignored in the performance test's focus on shorter-term outcomes. Alignment of the performance test to APRA guidance to participants in the market on how to interpret trustee covenants would provide more certainty to investors.

⁸ Chant West, November 2021, YFYS Performance Test: Good Intentions Marred by Collateral Damage, <https://www.chantwest.com.au/resources/yfys-performance-test-good-intentions-marred-by-collateral-damage/>

⁹ Conexus Institute, July 2022, *Assessing the impact of YFYS through interviews with CIOs of funds with performance 'buffer'*, p.5, <https://theconexusinstitute.org.au/wp-content/uploads/2022/07/Final-survey-paper-20220726-Conexus-IM-Final.pdf>

¹⁰ Frontier Economics, September 2021, Super Performance Test, p.2, <https://www.frontieradvisors.com.au/wp-content/uploads/2021/09/YFYS-performance-test.pdf>

¹¹ Frontier Economics, September 2021, Super Performance Test, p.4, <https://www.frontieradvisors.com.au/wp-content/uploads/2021/09/YFYS-performance-test.pdf>

¹² APRA, November 2021, Prudential Practice Guide CPG 229 Climate Change Financial Risks, [Final Prudential Practice Guide CPG 229 Climate Change Financial Risks \(apra.gov.au\)](https://www.apra.gov.au/prudential-practice-guide-cpg-229-climate-change-financial-risks), p.10.

- **Identify reasons for performance test failure.** In the event of a failure of the performance test, it may be appropriate to allow the regulator to investigate further before taking action. For example, Chant West recommends that a first failure of the test should trigger an APRA review to determine whether there is a clear path to improvement or whether the fund product is unlikely to recover.¹³ This would allow for a deeper consideration of the causes of the performance test failure, such as whether it reflects chronic underperformance or temporary historical factors.

¹³ Chant West, November 2021, YFYS Performance Test: Good Intentions Marred by Collateral Damage, <https://www.chantwest.com.au/resources/yfys-performance-test-good-intentions-marred-by-collateral-damage/>