PRI RESPONSE

AUSTRALIAN TREASURY: YOUR FUTURE, YOUR SUPER REVIEW

October 2022

INTRODUCTION

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's consultation on the Your Future, Your Super (YFYS) measures.

ABOUT THIS CONSULTATION

On 7 September 2022, Treasury released a consultation paper seeking feedback on the unintended consequences and implementation issues from the YFYS measures introduced through the *Treasury Laws Amendment (Your Future, Your Super) Act 2011* and associated regulations. The YFYS measures include performance tests, YourSuper comparison tool, stapling, and the best financial interests duty. The focus of Treasury's review is to ensure that Australian superannuation funds perform better, deliver dignity in retirement, and avoid perverse outcomes for members.

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KEY RECOMMENDATIONS

The PRI welcomes Treasury's review of the YFYS measures as part of the Government's commitment to strengthening Australia's superannuation system. Effective measures to ensure accountability and transparency across the superannuation system can help improve member outcomes and engagement. However, if these measures are not appropriately 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.

In their current form, the YFYS measures are likely to have such unintended consequences. In particular, the design of the performance test and the imposition of a reverse onus of proof, as part of the best financial interests duty (BFID), have the potential to encourage investment strategies and decisions that conflict with superannuation trustees' duty to act in their members' best financial interests. This risk is exacerbated by the lack of explicit recognition within the existing prudential architecture of the need for superannuation funds to take into account longer-term sustainability-related system-level (market-wide) risks.

Because the performance test focusses on a narrow measure of short-term performance, there is a high likelihood that superannuation trustees will be constrained in how they consider and respond to such risks. Longer-term system-level risks are now widely recognised to have significant potential impacts on financial performance. Investors globally, as well as in Australia, are taking steps to mitigate and respond to these risks by, among other things, intentionally pursuing sustainability outcomes. In some cases this will require the pursuit of strategies that result in variance from short term-focussed benchmarks, in order to achieve longer term objectives. Failure to allow for this flexibility within the design of the performance test could lead to perverse outcomes for members.

The imposition of a reverse onus of proof as part of the BFID may also hinder actions designed to address longer term, system-level risks, including through the pursuit of sustainability outcomes. In this respect, the reverse onus of proof places a disproportionate burden on superannuation trustees to quantify all costs (including stewardship resourcing and other related expenditure) and to justify each investment decision according to the immediate benefits to performance.

Finally, the extension of the performance test, in its current form, to Choice products, could also create the perverse outcome of undermining members' ability to choose products that best meet their own financial and sustainability objectives.

In order to address these potential unintended consequences, our key recommendations are:

- Treasury should evaluate and further consult with industry on potential solutions that remove or minimise any restrictions imposed by the YFYS measures on trustee's ability to mitigate system-level risks and pursue desired sustainability outcomes to support better long-term returns.
- The Government should reinstate the common law burden of proof that applies to the best financial interests duty.
- Choice products should not become subject to the performance test in its current form. To the extent that they are, an exemption should be applied for all values-based products (i.e., products whose investable universe is limited because it applies an investment strategy that prioritises members' sustainable or ethical values) rather than solely faith-based products.
- The Government should add a covenant under the *Superannuation Industry (Supervision) Act 1993* (Cth) for superannuation trustees to consider and address system-level risks when formulating investment strategies, and Treasury should support APRA to modernise and update its prudential architecture, standards, and guidance accordingly.

DETAILED RESPONSE

When they were introduced, the YFYS measures were aimed at increasing member engagement, reducing fees, increasing performance, and better holding trustees to account for the decisions they make. Effective measures to ensure accountability and transparency across the superannuation system are welcome. However, in their current form, the YFYS measures are likely to have a number of perverse outcomes that constrain trustees ability to act in the best financial interests of their beneficiaries, impose unnecessary compliance costs, and undermine member choice.

To maintain and improve long-term financial performance in their beneficiaries' best financial interests, superannuation trustees have an implied duty to consider whether there are any sustainability-related system-level risks (i.e., systematic and systemic risks) that may affect returns and, if so, how they can mitigate those risks.[1] Such risks are sometimes also referred to as market-wide risks. For superannuation funds, whose highly diversified portfolios effectively represent a slice of the overall market, investment returns depend not only on decisions as to what to invest in, but on the stability and viability of environmental and social systems that the economy relies on. There is therefore a clear incentive for superannuation funds to act to address such outcomes. Many investors, globally, as well as in Australia, are now taking such actions.

Accordingly, legislative and regulatory frameworks should explicitly require superannuation funds to address such risks.[2] 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.

Separately and additionally to this need to address system-level sustainability-related risks, there is a growing expectation that superannuation trustees account for and respond to their members' sustainability objectives and preferences and provide products that adequately meet these needs. The active consideration of such preferences can improve member engagement and outcomes but may similarly be hindered by the current narrow short-term focus of the performance test.

In this context, certain components of the YFYS measures, are likely to have unintended consequences, counter to their objectives, including by constraining superannuation trustees ability to mitigate system-level risks and take into account and provide products that appropriately address members' sustainability preferences. We highlight these issues and make recommendations to address them in our responses to questions 4, 9, 11, 17, and 19.

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[1] Freshfields Bruckhaus Deringer, PRI, United Nations Environment Programme Finance Initiative, Generation Foundation (2021), A Legal Framework for Impact: Sustainability impact in investor decision-making.

[2] PRI, (2022), A Legal Framework for Impact: Australia.

PERFORMANCE TESTS

Question 4: What are the longer-term impacts of the performance test on market dynamics and composition? How will these factors impact on long-term member outcomes?

The current performance test fails to account for the long-term system-level risks that may affect product performance. Longer-term system-level risks are now widely recognised to have significant potential impacts on financial performance. Investors globally, as well as in Australia, are taking steps to mitigate and respond to these risks by, among other things, intentionally pursuing sustainability outcomes. In some cases, this will require the pursuit of strategies that result in variance from short term-focussed benchmarks, in order to achieve longer term objectives. Failure to allow for this flexibility within the design of the performance test could lead to perverse outcomes for members.

Although the performance test currently assesses a product's performance over eight-year terms, the test only measures performance against backward-looking indices. It can erroneously penalise products that apply forward looking, long-term investment strategies seeking to address system-level risks that may impact performance over a 10-to-30-year time horizon.

As a result, the performance test, in conjunction with APRA's heatmap assessments, may encourage superannuation trustees to move towards passive investment strategies that are focused on the short term to minimise the risk of failing either test. In these circumstances, superannuation trustees may be disincentivised from taking proactive actions to mitigate system-level risks where the financial benefits of doing so are only likely to be realised in the long-term.

We encourage Treasury to evaluate and further consult with industry on potential solutions that will remove or minimise any restrictions imposed by the performance tests and heatmap assessments on superannuation trustee's ability to mitigate system-level risks and pursue desired sustainability outcomes.

Question 9: What would be the impact of extending the current performance test to other Choice products (such as single sector or retirement products)? How could any issues be addressed?

Our recommendation is that the performance tests, in their current form, should not be extended to Choice products.

Superannuation members intentionally select Choice products as an alternative to MySuper products. In many cases this selection may be based on sustainability-related preferences or objectives, as well as their financial objectives. For certain Choice products that emphasise their alignment with sustainability objectives, membership has continually increased over the past few years.

However, the benchmarks used in the current performance tests do not adequately reflect such investment approaches. In this respect, it is plausible that there may be variations in these values-based products' performance against standardised benchmarks where those benchmarks do not account for a range of non-financial factors in investment approaches (e.g., ethical, faith-based, environmental, social/human rights or corporate governance considerations).

Although there is no evidence that they would have underperformed, we are aware that certain values-based products are considering whether they will need to change their investment approach if they become subject to the current performance tests. In circumstances where these Choice products' agreement with members is that they will pursue real world, sustainability outcomes, the superannuation trustees may have to wind up these products if the current performance tests inadvertently force them to constrain their investment approaches. This would have the perverse effect of decreasing choice for members.

Accordingly, we recommend that Treasury consider the following alternatives:

- Choice products do not become subject to performance tests in the current form; or
- Choice products become subject to the current performance tests. However, values-based products[3] should be treated with the following exceptions:
    - if a values-based product does not pass the performance test requirements, the consequences of a fail assessment should not immediately apply. Rather, APRA should undertake a subsequent assessment of the product against alternative methods that better account for ethical and sustainable investment approaches; and
    - if a values-based product does not pass this alternative performance test, the superannuation trustee must notify existing product members of its fail assessment and provide them with an opt-out option. However, the values-based product should retain the option to accept new members given that (a) superannuation members' are increasingly choosing funds that pursue ethical and sustainability goals and (b) often performance of values-based funds are better measured over a long-term horizon.

YOURSUPER COMPARISION TOOL

Question 11: To what extent would altered or additional metrics, or improved functionality, make the tool more effective while ensuring it remains simple and clear? What more can be done to ensure that new employees are able to choose high-performing superannuation products that are appropriate for their needs?

We encourage Treasury to consider how the YourSuper Comparison tool (the Tool) can be used by individuals to compare different products' approaches to shaping sustainability outcomes as well as their actual impact on sustainability outcomes.

The Tool currently only allows individuals to compare MySuper products' fees and net returns. However, evidence increasingly shows that individual investors want their investments to contribute to positive or reduce negative sustainability outcomes in the real world.[4] Research by the Responsible Investment Association Australasia shows that 80% of Australians expect their investments to have a positive impact on the world.[5] Broader surveys have found that more than 50% of individual Australian investors are interested in realising positive change through their investments.[6]

[3] Whether a superannuation product is deemed a values-based product should be determined by APRA and could be based on whether the product has a limited investable universe because it applies an investment strategy that prioritises members' sustainable or ethical values (i.e., pursuing the protection of the environment or the amelioration of social issues).

[4] 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)

[5] These expectations can drive investment behaviours with 61% of Australians stating they would save and invest more if they knew their savings made a positive difference in the world. See Responsible Investment Association Australasia (2022), From Values to Riches 2022: Charting consumer demand for responsible investing in Australia

[6] Fidelity International (2022). Fidelity survey: APAC investors' strong interest in sustainable investing continues, with a confidence challenge still to tackle

The Tool could facilitate individuals to inform superannuation funds of their sustainability values, interests, and concerns, and select products based on those preferences. This information could also potentially be used to inform superannuation fund's strategic objectives. Given ongoing regulatory and market developments in this area, Treasury should evaluate what role the Tool should play in supporting beneficiaries' sustainability preferences following the development of ASFI's Sustainable Finance Taxonomy and the further investigatory work ASIC are undertaking into greenwashing.

BEST FINANCIAL INTERESTS DUTY

Question 17: To what extent has the BFID required trustees to change their processes and procedures? Has this caused any unintended consequences or impacted member outcomes in any way?

We acknowledge that the semantic change to the best financial interests duty (**BFID**) under the YFYS measures is arguably consistent with the judicial interpretation of the original best interest duty. Notwithstanding the materiality of sustainability-related factors to financial performance, we believe that the BFID may implicitly discourage some superannuation trustees from taking into account these system-level risks and their impact on returns over the long-term.[7] This risk is further exacerbated by the lack of explicit recognition within the existing prudential architecture of the need for superannuation funds to take into account longer-term sustainability-related system-level (market-wide) risks.

Accordingly, we encourage Treasury to:

- consider amending the *Superannuation Industry (Supervision) Act 1993* (Cth) s 52(6) to ensure that superannuation trustees' covenants explicitly set out the requirement for them to consider and address system-level risks when formulating their investment strategies;
- support APRA to modernise and update its prudential architecture, standards and guidance accordingly; and
- consider and address how the sole purpose test impacts superannuation funds' consideration of members' sustainability preferences and the pursuit of sustainability outcomes.

Question 19: Is the reverse onus of proof the most appropriate way to achieve the objective of improving member outcomes?

The reverse onus of proof is not the most appropriate means of achieving greater accountability and may result in increased costs and hinder actions designed to address longer term, system-level risks, including through the pursuit of sustainability outcomes.

While we appreciate the intention behind these reforms, we consider that the reverse onus of proof restricts superannuation funds from acting in their members' best interests in the long-term. In conjunction with the performance tests, the reverse onus of proof places a disproportionate burden on superannuation trustees to quantify all costs (including stewardship resourcing and other related

[7] See Corrs Chamber Westgarth's analysis in 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.154-p.155).

expenditure) and justify each investment decision according to the immediate benefits to performance.

This may unhelpfully constrain superannuation funds and products that are pursuing benefits over a long-term horizon (i.e., 10 to 30 years). Accordingly, we encourage the Government to reinstate the common law burden of proof that places the evidentiary onus onto the plaintiff or prosecution.

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 Treasury further to ensure Australian superannuation funds perform better and achieve outcomes in the best interests of members.

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

More information on www.unpri.org