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Your Future, Your Super Review

Dear Shibani

Thank you for the various consultation initiatives you and your team have facilitated for the Your Future, Your Super Review (the Review). The issues we raise in this submission, along with their corresponding remedial recommendations, have been raised with your team throughout the Review period. A number of these issues relate to what some term as ESG related issues. However, throughout this submission we refer to values-based products, which are those that have investment strategies that are invested in line with specific beliefs on either religion, the environment or social issues. It is these particular products that face significant unintentional consequences from the Your Future, Your Super framework.

About Future Super Group

Future Super Group (FSG) is a superannuation and sustainable investment firm with 268,575 members and $9.6bn in funds under management and administration as at the end of August 2022. Our mission is to create a prosperous future for both our members and the wider community that is free of climate change and inequality. Core to our investment philosophy is the belief that we have a responsibility to invest sustainably. This helps protect our members' future - both physically and financially. We have built expertise on how to manage climate risks and opportunities in our investment portfolios with a focus on the economic transformation required for the world to achieve a just transition to a 1.5 degrees warming scenario. This suits the long term investment horizon of our members, enables them to use the power of their money to be part of the collective divestment movement against major climate change contributors such as fossil fuel companies, as well as invest in initiatives that produce positive social and environmental outcomes.

Over the past five years FSG's flagship fund, the Future Super Fund, has grown 7.5 times faster than the overall industry. The Future Super Fund has been identified by APRA as one of only 13 funds that exceed all three of its viability metrics, indicating that it is amongst the fastest growing and most financially viable funds in Australia. Our success to date is reflective of the broader trend in the ethical super movement, which has grown at 2.5 times the overall industry over the past five years. A study published earlier this year[1] highlighted that 74% of the population would consider moving away from their current financial institutions if these institutions were investing in companies that did not align with their values. Our growth is strong evidence that people are increasingly taking action to align their super with their values, explicitly selecting sustainability as a key objective for and use of their super asset.

[1] https://responsibleinvestment.org/wp-content/uploads/2022/03/Media-Release_FromValuestoRiches2022_2.pdf

Recommendations

- FSG recommends that values-based products, which include dedicated ethical and sustainable products, to be included within the scope of the faith-based product performance test framework or values-based product-specific benchmarks to be added to the performance test that can only be used by qualifying products. Either of these actions would help address the unintended existential threat posed by the performance test on these types of products.

- FSG recommends APRA to establish a Performance Test Governance Group to oversee the ongoing efficacy and scope of the benchmarks.

- FSG recommends that the consequence of a MySuper product failing the performance test should be modified to enable APRA to apply a multi metric assessment to better understand the cause of failure and where there are mitigating factors, such as strong evidence of pre-emptive behaviour modification, the product shall be deemed to have passed the test.

- FSG recommends that the consequence of a choice product failing the performance test should be modified to enable APRA to apply a multi metric assessment to better understand the cause of failure and where there are mitigating factors, such as strong evidence of pre-emptive behaviour modification, the product shall be deemed to have passed the test. In addition, where no sufficient mitigating factors are found and this outcome occurs for two consecutive years, the product will not be closed to new members. This outcome preserves the fundamental characteristics of a choice product.

- FSG recommends that an additional investment covenant be added to section 52(6) of the *Superannuation Industry (Supervision) Act 1993* to include the requirement to consider and address system-level risks, which would result in the best financial interests duty encompassing long term investment performance instead of the current unintended shorter term focus that is created by the time frame embedded in the performance test.

Performance Test

Consultation question 2: Does the current set of indices used to calculate benchmark returns unintentionally distort investment decisions or reduce choice for members? If so, is there a way to adjust the benchmark indices while maintaining a clear and objective performance test?

FSG strongly believes that the current set of indices used to calculate benchmark returns unintentionally distorts investment decisions across the industry and particularly of dedicated values-based products, which include ethical and sustainable products. Coupled with the consequences of failing the performance test, which include being closed to new members, the indices currently used represent an unintended existential risk to dedicated sustainable funds like the Future Super Fund.

Dedicated values-based products have investment strategies that are invested in line with specific beliefs on either religion, the environment or social issues, which result in a material reduction in the size of the investable universe that is available to invest in. An example of this situation is the S&P ASX 300 index, which is used in the performance test to calculate benchmark returns for the Australian equities asset class. In line with the objectives of members of the Future Super Fund, we exclude some of the largest companies in the ASX 300 from our domestic equity asset class such as fossil fuel exposed energy companies and their key service providers like the major banks. Therefore, a mismatch occurs between what the performance test measures and the values of members, which in essence penalises members for holding those values. These values are congruous with long term investment beliefs and rooted in best financial interests.

The Conexus Institute, London Stock Exchange Group, Responsible Investment Association Australasia and the Australian Sustainable Finance Institute are working together to explore the implications of the performance test for portfolios that differ to the benchmark due to values-based positioning. The initial results suggest that the performance test tracking error created by these activities would more than exceed what is estimated as an appropriate tracking error budget for super funds wishing to minimise their risk of failing the performance test. We understand this work will be shared with Treasury in due course and will support the need for values-based products to face a more relevant performance test framework.

FSG believes there are two viable ways in which this issue can be addressed:

1. Expand the scope of the faith-based product framework to include values-based products.

   As faith-based products are a subset of values-based products, we believe it is a logical step to expand the proposed faith-based product performance test framework, which includes the use of a supplementary performance test, to values-based products. The expansion to values-based products could be implemented by adopting specific definitional parameters. Utilisation of an overarching 'values-based' product definition that appropriately captures products that have clear investment mandates based on specific beliefs on either religion, the environment or social issues would cover relevant products where the investable universe is materially restricted.

- The appendix to this submission details how such definitional parameters could be drafted. The structure mirrors that of the proposed faith-based product legislation.

OR

2. Include values-based product-specific benchmarks into the current performance test.

   This approach would result in multiple benchmarks for the same asset class. However, relevant indexes for values-based products are limited and currently exist only for equities (domestic and international) and fixed interest asset classes. Such an approach would still require a definitional framework to ensure only dedicated values-based products could access these benchmarks. The definitional framework outlined in the appendix could also be used in this scenario.

The proposed definitional framework is narrow in its scope. This has been a deliberate design choice as this guards against the risk of greenwashing and gaming. Our analysis indicates that the population of products that would be captured by our proposed definition of values-based is only around 45 (if all qualifying products were to apply for values-based product status), representing approximately 0.6% of the super sector's assets.

The critical nature of the underlying indices and resulting benchmarks should mean adequate on-going attention is placed on them. The discussions during the Technical Working Group meetings highlighted the value of experts reviewing the benchmarks. FSG also anticipates that benchmarks will evolve as Australia transitions towards a clean economy. This significant structural change will present many opportunities for long term investing so it is critical that the performance test benchmarks are dynamic enough to reflect them and therefore not inadvertently create a barrier for super funds to invest in initiatives that support this transition.

We recommend that a Performance Test Governance Group (PTGG) be established by APRA to oversee the ongoing efficacy and scope of the benchmarks. The PTGG should be chaired by APRA and include asset class-specific experts.

Consultation 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?

Unchanged, the longer term impacts of the current performance test may result in values-based products exiting the market. This would be a perverse outcome given the significant growth this segment is experiencing and evidence of the positive long term risk adjusted returns on offer via this strategy. Superannuants are exercising choice, a key feature of the sector's design since 2012, to align their values to their super. The fact that this is occurring in the values-based product set reflects that there is a growing proportion of the population who do not want their super invested in the ways implied by the generic benchmarks that comprise the performance test. Ultimately if not addressed, this growing cohort of superannuants will be incentivised to move to the self managed super fund (SMSF) sector. Given the significantly lighter regulatory framework of the SMSF sector, this would represent a poor public policy outcome.

Our recommendations under *consultation questions 2* and *8* would address this issue.

Consultation question 6: Have the consequences been effective at encouraging trustees to improve their performance or merge with better performing funds? Are there ways this could be improved?

The binary pass/fail consequence of the performance test is creating unintended incentives for trustees to prioritise tracking error management and investment strategy implementation over and above the quality of the actual investment strategy and alignment to member outcomes. We understand that the design of the performance test will not change, and as such believe that what happens after a product fails needs to be modified in order to address the unintended incentives.

We recommend that a fail outcome should trigger APRA to investigate the cause of the failure. In order to counter the flaws of the performance test, multiple metrics should be used by APRA to assist with its assessment. The heatmap infrastructure has already been built and would be largely sufficient for a multi metric assessment. We recommend adding a risk-adjusted return metric to the heatmap to make it appropriate for this purpose.

If APRA's assessment determines there are no mitigating circumstances to the fail outcome, the product shall be deemed to have failed. If this process results in the same outcome for a second concurrent year, the product is closed to new members. However, if APRA assesses that the product has mitigating factors explaining the initial fail result, such as strong evidence of pre-emptive behaviour modification, the product will be deemed to have passed the test. This approach will ensure a more precise operation of the performance test.

Consultation question 8: Are there any significant issues to be expected when the test is extended to TDPs? If so, how could these issues be addressed?

FSG believes there will be significant issues in extending the performance test to multi-sector choice products. Unchanged, the existing framework will treat choice products in the same manner as MySuper products. Such an outcome would undermine the purpose of choice architecture.

We believe the same process we recommended under *consultation question 6* on how APRA should respond when a product initially fails the performance test should also be applied to choice products. However, if APRA's multi metric assessment leads to the product still failing the test and this occurs for two consecutive years, it should not be closed to new members. Instead, the existing disclosure requirements would represent the extent of the consequence. This would preserve the fundamental characteristic of the choice product - an individual has actively chosen to put their super in a specific product. Values-based products are an example where a growing number of people are choosing to align their personal values with their super fund. This approach would also ensure there is a heightened level of protection for MySuper members, who have not made an active choice to join that fund and are therefore considered to be less engaged with the product.

We note that APRA continues to have other tools to facilitate the exit of choice products where there are major prudential concerns. Significant issues around governance, risk management and sustainability are examples where APRA is able to act to effect remedial actions that can ultimately lead to the closure of a product.

Best financial interests duty

Consultation 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?

FSG supports the implementation of the best financial interests duty (BFID). The demographic of the Future Super Fund is young, with an average age of 30. The investment horizon of these members spans multiple decades and our investment strategy has been designed to align with this profile. For example, the transition that Australia has commenced to become a clean economy, which entails the prevalence of renewable energy and decarbonisation initiatives across all industries, presents many long term investment opportunities that will benefit from this major structural change. In line with the Future Super Fund's values and investment strategy, it is invested heavily in such opportunities, which we view as fully aligned to the BFID.

However, a significant unintended consequence of the BFID is that due to the eight year rolling timeframe of the performance test, the practical reality of BFID is that the true long term best financial interest of members from an investment perspective will be deprioritised. The embedded lookback period of the performance test means the BFID is further incentivised to focus on only the next year of investment performance. This unintentional short term application of the BFID from an investment perspective does not align to the long term nature of super.

We recognise the difficulty in altering the timeframe of the performance test. In order to offset the incentive to focus on short term investment performance, we believe the regulatory framework needs to better support long term consideration. A way to achieve this is to require "system-level" risks to be considered when formulating investment strategies.

As outlined by the UNPRI[2], system-level risks is a catch-all term for systematic risk and systemic risk, both of which have implications for investment performance. Systematic risk is defined as risk, transmitted through financial markets and economies, that affects aggregate outcomes, such as broad market returns. Because systematic risk occurs at a scale greater than a single company, sector or geography, it cannot be hedged or mitigated through diversification. One example of a sustainability related systematic risk is the risk of reduced global economic growth due to sustained physical impacts of climate disruption. Systemic risk is defined as the risk that an event at a particular point in time or a chronic economic condition de-stabilises the financial system or leads to its collapse. An example of a systemic risk materialising would be a number of "too-big-to-fail" financial institutions defaulting on obligations to their creditors or investors. An example of a sustainability-related systemic risk would be a sudden repricing of assets across the fossil fuel sector, resulting in cascading defaults that destabilise financial markets.

Given the long term nature of system-level risks, we recommend that an additional investment covenant be added to section 52(6) of the *Superannuation Industry (Supervision) Act 1993* to include the requirement to consider and address "system-level" risks, when formulating investment strategies. This will make it clear that long term investment performance should be considered alongside the shorter term nature of the performance test.

Please contact Fahmi Hosain - Head of Government Relations & Regulatory Affairs - at fahmi@futuresuper.com.au or 0402 849 221 if you have any questions on our submission.

Your sincerely

Simon Sheikh

CEO

[2] https://www.unpri.org/a-legal-framework-for-impact/australia-integrating-sustainability-goals-across-the-investment-industry/10033.article

APPENDIX

Definition structure that could be utilised to expand the faith-based product performance test framework to values-based products

values-based mandate means the translation of a set of values-based principles into an investment strategy that materially restricts the investable universe, such as through company, asset and sector selection that is applied across the product's investment portfolio.

values-based principles means beliefs that relate to any of the following:

(a) the protection of the environment (including, for example, by reference to one or more issues such as biodiversity, climate change and sustainability);

(b) the amelioration of social issues (including, for example, by reference to one or more issues such as the abuse of human rights, perpetuation of social inequalities, animal exploitation and abuse, and commercial predation on vulnerable communities through addictive substances); and

(c) religion.

values-based product, in relation to a financial year, is a Part 6A product that is specified in the determination made by APRA under subsection 60L(4) in relation to the financial year.

values-based product determination by APRA

(1) The trustee or trustees of an entity that offers a Part 6A product may apply to APRA for the product to be specified in a determination under subsection (4) in relation to a financial year.

(2) The application must:

(a) be in writing and in the approved form; and

(b) contain a declaration by the trustee or trustees that:

(i) the investment strategy in respect of that financial year for the product has a clear values-based mandate; and

(ii) the values-based mandate has been translated into the investment strategy in respect of that financial year; and

(iii) that investment strategy has been disclosed in a document required under this Act or the *Corporations Act 2001* to be given to each beneficiary of the entity who holds the product in that financial year; and

(iv) that investment strategy has been disclosed, and in the future will be disclosed, in the entity's marketing materials; and

(c) set out one or more indices that APRA could use in making a determination under subsection 60C(2) for the product in relation to the financial year and later financial years; and

(d) if regulations made for the purposes of this paragraph specify information—contain that information.

(3) Regulations made for the purposes of paragraph (2)(d) may:

(a) specify information by reference to information specified in a legislative instrument; and

(b) empower APRA to make a legislative instrument for the purposes of paragraph (a).

(4) If the trustee or trustees give APRA the application within the period specified in subsection (5), APRA may make a determination in writing specifying the product in relation to the financial year.

(4A) APRA may only make a determination under subsection (4) if APRA considers that the matters set out in the declaration required by paragraph (2)(b) are correct and that the product accords with values-based principles and has been designed in good faith to do so.

(4B) Subsection (4A) does not limit APRA's power to refuse to make a determination under subsection (4) in relation to a product.

(4C) APRA may, by legislative instrument, set out matters to be taken into account in deciding whether to make a determination under subsection (4).