Property Council of Australia
ABN 13 00847 4422

Level 1, 11 Barrack Street
Sydney NSW 2000

T. +61 2 9033 1900
E. info@propertycouncil.com.au

propertycouncil.com.au
@propertycouncil

Australia's property industry
Creating for Generations

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Superannuation Efficiency and Performance Unit
Retirement, Advice and Investment Division
Treasury
Langton Cres
Parkes ACT 2600

By email: YFYS@treasury.gov.au

Dear Sir/Madam

Review of Your Future, Your Super Measures

The Property Council of Australia welcomes the opportunity to provide comments to the review of *Your Future, Your Super* (YFYS) legislation and accompanying regulations announced in September 2022.

The Property Council champions the industry that employs 1.4 million Australians and shapes the future of our communities and cities. Property Council members invest in, design, build and manage places that matter to Australians: our homes, retirement villages, shopping centres, office buildings, industrial areas, education, research and health precincts, tourism and hospitality venues and more.

Our members include some of the largest superfunds which invest across the property spectrum. The views provided in this submission are primarily focused on the impact the YFYS performance test has had, or could have, on superfund investment into property. We also consider the broader impact of the reforms and how they interact with other superannuation policy frameworks.

Overall design of the YFYS performance test

Appropriate policy settings are needed to ensure that the superannuation system delivers on its intended goal of increasing the financial well-being of people whose savings are managed within the system. This includes assessing the performance of funds and identifying those funds that are markedly underperforming the broader industry – policy objectives which the Property Council supports.

However, the current design of the YFYS performance test may in fact lead to poorer outcomes for superfund members.

The performance test uses a formula to calculate the actual return to compare a benchmark return for each fund. Actual and benchmark returns are measured and weighted based on the asset class mix of each fund, and specific indices are used as benchmarks for every asset class. This essentially means that in practice, the performance of each asset class in a fund is measured against some sort of representative index. But because of the potential tracking error (i.e. deviation away from a benchmark) created through the use of any particular benchmark, superfunds are potentially discouraged away from investments that are not included within the representative index. The focus on asset level performance indices that roll up to an overall performance measure also fails to take into account strategic asset allocation decisions at the fund level that are known to be some of the most important decisions towards achieving optimal total risk-adjusted returns. Furthermore, the risk of underperforming is steep, especially if the performance test is failed over two consecutive years.

This could lead superfunds to put greater emphasis on strategic asset allocations and investment strategies that "track" the relevant performance indices – resulting in greater concentration of investment in assets or investments that reflect the relevant performance indices to the detriment of other assets or investments that sit outside the indices.

Applying a performance test at the 'whole of fund' level may remove some of these challenges and unintended consequences. However, this would be a significant departure from the current design of the performance test and would require broad consultation and support across the industry. If this is an option for consideration, we would welcome a further discussion to provide a more targeted response with the benefit of consultation with our member base.

Our submission below is drafted on the assumption that the overall design of the performance test remains broadly the same, and the benchmarks are applied at the asset level.

Role of property in a diversified investment portfolio

Property is seen as an essential part of a balanced and diversified investment portfolio, generating stable long-term returns for investors. The superannuation industry held almost $180b worth of property investments (both listed and unlisted) as of June 2022.[1] As a result, there are 16 million Australians with a stake in property through their superfunds. This investment underpins Australia's commercial property market, including world class office buildings, industrial precincts, shopping centres and residential dwellings such as aged care, affordable and social housing. It is also a major driver of economic activity and jobs creation for the property and construction industries.

Looking ahead, Australia's need for investment will continue to grow strongly. Australia is the most urbanised country in the world and despite the COVID-pandemic, our cities will continue to grow. This growth will require significant investment in real estate and infrastructure to ensure our cities remain both liveable and continue to be engines of economic prosperity. We will need more homes, offices, retail centres, industrial sites, retirement living, student accommodation, hotels and community, cultural and sporting precincts.

In addition, superfunds – as some of the largest domestic institutional investors – are uniquely placed to play an active role in the property sector's growing recognition and action on ESG issues. For example, buildings currently account for over 50% of Australia's electricity use and almost a quarter of our carbon emissions. Investors will be vital to the property industry adapting to more energy efficient and less carbon-intensive practices in order to contribute to Australia meeting its net zero emissions targets.

[1] APRA Quarterly superannuation performance statistics, June 2022

We also recognise the opportunity for Australia to have greater institutional investment in housing, similar to overseas markets such as the US, UK and Japan that have robust long-term purpose-built rental accommodation for at-market, frontline worker and affordable housing cohorts.

Superfunds and their members are well placed to capitalise on these property investment opportunities which provide long-term stable financial benefits for investors, shape our cities and regions and drive economic prosperity for the benefit of all Australians.

Given the importance of superfund investment into property and other sectors of the economy, policy measures which assess superfund investment performance should create a level playing field and not inadvertently discourage certain types of investments.

Indeed, some of our superfund members have noted that they have decreased their allocation to property as a result of the introduction of the YFYS performance test.

Impacts of the property performance benchmarks

Property assets under the YFYS performance test are split into four covered asset classes (with respective benchmarks shown for each in the table below):

Covered asset class	Assumed index
Australian listed property	S&P/ASX 300 A-REIT Total Return Index
International listed property	FTSE EPRA Nareit Developed ex Aus Rental 100% Hedged to AUD Net Tax (Super) Index
Australian unlisted property	MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index – NAV-Weighted Post-Fee Total Return (All Funds)
International unlisted property	MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index – NAV-Weighted Post-Fee Total Return (All Funds)

The assumed indices for Australian listed property and international listed property are working appropriately – noting in particular that both are representative (i.e. appropriate for each relevant asset class), transparent (with publicly available information on how the benchmark is constructed), and investable.

The current Australian unlisted property benchmark is the MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index (the MSCI index). This benchmark captures a range of funds that primarily invest in 'core property' assets – mostly office, retail and industrial property. Counterintuitively, the international unlisted property benchmark is also the MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index.

The MSCI index was recommended by industry for Australian property because it is one of the most common industry benchmarks for the performance of unlisted property assets in Australia and incorporates the impact of gearing, fees and active asset management. It also has a sectorial mix which is more closely aligned to what superfund trustees deem as being able to provide long-term stable returns in terms of core property.

As noted above, the use of a benchmark can create concern around investments that may result in deviations away from the benchmark. Given the MSCI index focuses on core property assets, this can result in potential tracking error risks for:

- Investments in non-core commercial property such as data centres, childcare centres and importantly residential assets, such as social and affordable housing, Build-to-Rent housing, purpose-built student accommodation, aged care or NDIS accommodation.
- Investments in development or upgrading of assets given the higher risk nature of these activities.

For example, a superfund may consider an opportunity to invest in rehabilitating an obsolete B-grade office buildings to modern standards. This investment will provide no returns for the first few years (as the building is emptied during construction and therefore there is no rent) whilst the YFYS benchmark continues to generate a positive return. Depending on the length of the project (as it may take another year to lease up and generate rental income), the fund will find itself needing to make up for the relative 'underperformance' of that investment during what remains of the YFYS measurement period of eight years. For example, if the development earns nothing for three years, the superfund will be required to earn a significantly higher return over the remaining five years to simply breakeven with the YFYS benchmark. Superfund trustees will therefore have to weigh the respective opportunities and this example shows that YFYS can discourage some forms of investment and encourages the acquisition of 'safer' core properties that provides a return from day one.

We note that the Federal Treasurer and Housing Minister have been publicly calling for superfunds to increase their investment in housing. While this has been difficult for superfunds to execute due to the marginal nature of returns in the residential housing sector, particularly for affordable rental product which is by definition below-market rents, the tracking error risk presents an additional hurdle that must be accepted or overcome to enable such investments to occur. The superfund trustee's decision will therefore be weighed by the 'higher risk' of Australian residential property not just due to its absence in the YFYS benchmark but also by not having a commensurate return in order to achieve a balanced risk-adjusted return.

It remains unclear whether a more appropriate benchmark could be adopted to replace the MSCI index. We have undertaken robust consultation with members on alternative solutions, and cannot readily identify a different property benchmark that meets the three criteria of being representative, transparent and investable whilst being flexible enough to encourage investments into alternative properties that align with the Government's policy objectives. However, we remain very concerned about the impact of the current benchmark and overall YFYS performance test methodology for future investment in alternate assets. We recommend that the Government carefully monitors how these impacts might play over the years ahead.

There is, however, an obvious misalignment with the international unlisted property benchmark referencing the MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index. The design results in significant tracking error for every investment internationally and therefore discourages international property investments. International property investments provide opportunities to access property sectors in scale (such as multifamily, data centres, self-storage and medical office) that may not necessarily be readily accessible or scalable in Australia and therefore provides material diversification benefits to superfund property portfolios. There are several international property benchmarks (such as the MSCI Global

Quarterly Property Fund Index) and we are open to further discussion with the Government to discuss appropriate options for consideration.

Competing policy priorities

The introduction of the YFYS reforms has highlighted the potential dislocation that can arise between distinct policy frameworks with competing policy objectives that apply directly and indirectly to the superfund industry.

A relevant case in point for superannuation is the interaction of the YFYS measures with ASIC's Regulatory Guide 97 (RG97) on superfund fee and cost disclosure.

RG97 was introduced with the intention of ensuring that superfund members have accurate information regarding superfund fees and costs to help their decision making in choosing superannuation products. The aim was to provide a consistent and transparent approach to fees and costs disclosure to issuers of certain superannuation products – again we have no concerns with the policy intent behind RG97.

However, in the property sector superfunds are discouraged away from certain types of investments because of how RG97 accounts for them.

A prime example is the treatment of stamp duty under RG97. While state-based stamp duty is widely understood to be an unavoidable tax, it is recorded as a transaction cost under RG97 and therefore required to be disclosed, unlike other types of taxes. This can lead to some funds shying away from investing directly in property, even if the risk-adjusted return on the investment is higher than for other investments which don't incur stamp duty as a cost.

In contrast, stamp duty related to certain infrastructure investments isn't disclosed for the purposes of RG97. This anomaly is caused by how RG97's interposed vehicle test and definition have been set, which puts direct property investments at a disadvantage to other types of direct investments in unlisted assets because the same types of costs don't have to be disclosed for those investments.

An example of an unintended consequence of how RG97 interacts with broader policy objectives is in the context of achieving Australia's emissions reduction target of 43% and the commitment to net zero emissions by 2050.

If a superfund wanted to invest and hold a "net zero" commercial building, it could broadly do this in three ways:

- Buy a completed building that meets the net zero targets;
- Buy an existing building and upgrade it to meet net zero targets;
- Buy vacant land and build a new building that meets the net zero targets.

The first option is not particularly helpful as there is no marginal improvement towards net zero as the building was already created and it simply represents a secondary trade of the building. The last option would likely have the lowest stamp duty cost as stamp duty is only paid on the vacant land value, and therefore has the least impact on RG97 fees and costs disclosures. The second option would likely produce the best environmental outcome, as any embodied carbon in the existing building is repurposed and there is not additional carbon generated through the construction of the asset. This is suboptimal from an RG97 perspective however, as the stamp duty is incurred on the value of the land and the existing building, therefore requiring full allocation of the cost to the superfund.

This simple example demonstrates the competing policy objectives at play each time an investment is undertaken. Likewise, the YFYS performance test and potential for tracking error encourages a low risk, 'core property' investment approach that discourages risk-taking via direct investment into property to refurbish and upgrade buildings in order to make them more energy efficient and reduce their emissions.

Another example of competing policy priorities that affects superfunds is the APRA Prudential Practice Guide *CPG 229 Climate Change Financial Risk*.

Under this guidance, APRA has emphasised that superfunds need to take a governance and risk-based approach to the management of the various risks and opportunities arising from climate change.

To comply with this guidance, superannuation funds may need to deviate away from YFYS benchmark tracking strategies which are not congruent with, or deemed too risky with regard to, the risk management framework and practices set out in the guidance.

This creates a challenge for superfunds in effectively managing climate risks whilst at the same time aligning performance to YFYS performance benchmarks.

It is critical that a balance is sought between competing policy goals, and that government policies do not inadvertently create misguided incentives that discourage certain types of investments that otherwise would be appropriate.

Next steps

As part of this review of the YFYS performance test (among other YFYS measures), the Government should take into consideration the importance of removing unnecessary hurdles or roadblocks for superfunds to invest in property. A robust superfund performance test would give the industry more confidence that high quality domestic investors are putting capital to work in the market.

There are some challenges with the current performance test methodology and settings as they apply to the unlisted Australian property asset class that have been identified in this submission. It should be recognised, however, that there is an obvious misalignment by having the international unlisted property benchmark referencing the MSCI/Mercer Australia Core Wholesale Monthly Property Fund Index and there are a number of more suitable options.

We would be keen to continue providing feedback to Treasury on these impacts and any necessary solutions to the design of the performance test and other aspects of the YFYS measures in the future as they become apparent.

If you would like to discuss any aspect of this submission further, please contact Kosta Sinelnikov on 0422 168 720 and ksinelnikov@propertycouncil.com.au or myself on 0400 356 140 and bngo@propertycouncil.com.au.

Yours sincerely

Belinda Ngo
Executive Director – Capital Markets