BlackRock.

2 May 2023

The Treasury
Langton Crescent
Parkes ACT 2600

Submitted via email to: YFYS@treasury.gov.au

RE: Superannuation Performance Test Regulations 2023

To the Treasury

BlackRock Investment Management (Australia) Limited (**BlackRock**) appreciates the opportunity to comment on the *Superannuation Performance Test Regulations 2023* (**Regulations**).

BlackRock is an Australian public company and licensed provider of financial services. In Australia we invest AUD $160-180 bn, predominantly on behalf of Australian retail and wholesale investors. We partner with the Federal Government, 5 state governments, and every large superannuation fund to provide specialist investment management, indexed, factor and active investment portfolios, and our bespoke investment technology, Aladdin.

We support the proposed amendments to the Regulations and hope to see them made as soon as possible.

Extending the lookback period progressively to 10 years will incorporate all available performance data, giving a more accurate picture of performance history. A longer test period also aligns better with trustees' fiduciary duties to members by encouraging a focus on long-term decision making. Given the retrospective nature of the performance test and the fact that trustees were not managing the portfolio with this consideration in mind, we again suggest that a higher 100 bps underperformance threshold would be more appropriate. A higher historical threshold would reduce the incidence of adverse risk-taking and risk-aversion behaviour in future asset allocation decisions, particularly as the test is rolled out to trustee directed products and beyond. In addition, it would provide some additional buffer to account for the simplistic tax assumptions used in the benchmark methodology which adds an additional source of uncontrollable performance tracking error relative to the benchmark.

We support the disaggregation of the international equity, Australian and international fixed income, and alternatives asset classes. The risk and return characteristics of emerging market equities are different to those in developed markets and this should be acknowledged with separate benchmarks. Separate benchmarks will facilitate trustees' taking longer-term, strategic positions, which in turn will deliver better total returns to members.

The disaggregation of the Australian and international fixed income asset classes to include and exclude credit is an improvement, however we reiterate that APRA's sector categories (SRS550) for Fixed Income are unclear and should be rectified. For example, Fixed Income Excluding Credit includes investment grade credit but excludes non-investment grade credit, such as high yield.

We also strongly suggest that the Fixed Income asset class be disaggregated further to align with three distinct benchmarks. Ideally, the original Bloomberg Ausbond Composite 0+ Yr Index would be retained with the addition of two new benchmarks to allow for inflation linked bonds and floating rate strategies. Having three distinct benchmarks will facilitate the sizing of allocations to these asset classes independent of the weights in the Master index, similar to the disaggregation of the MSCI ACWI into developed and emerging markets components for equities.

For example, we note that the proposed Bloomberg Ausbond Master 0+Yr Index includes only a small allocation to inflation linked bonds (3.5% as at 31/03/2023). Providing a separate inflation linked bond index would give trustees the flexibility to allocate more or less to the asset class based on the investment outlook, without introducing tracking error risk to an aggregated fixed income benchmark. Given the medium-term outlook for inflation, we believe a standalone benchmark would allow trustees to make appropriate allocations to inflation linked bonds that reflect this environment. As an extension, the adoption of three distinct fixed income benchmarks would allow trustees to allocate confidently across the fixed income spectrum based on the current investment climate and the best interests of members, rather than being concerned with potential tracking error to an aggregated benchmark.

In addition to the changes proposed in this consultation and our response to these set out above, we think the performance test could still be further improved. The test should be subject to periodic review and improvement, so that it remains fit for a future where serious underperformance issues have been addressed and trustees have moved to a state of maintaining strong performance. We would therefore encourage the Government to consider further changes to the test in future, as detailed below.

Sustainable[1] benchmarks

Allowing an equivalent list of sustainable focussed benchmarks for key asset classes where trustees choose to adopt a sustainable approach to that asset class would encourage long-term sustainable investment decisions that respond to market conditions. The screening and construction methodology of sustainable indexes mean each trustee's portfolio will be very different in terms of stock, sector and country weights, and it would be appropriate to allow trustees to specify the customised sustainable benchmark to be used for the performance assessment as part of the SPS550 reporting.

Evaluate total returns as well as implementation

Broadening the components of the test so that it evaluates a product's total returns, adjusted to the risk in the portfolio, as well as the effectiveness of implementing the asset allocation, will ensure the best financial outcomes are achieved for members over the long-term. Total returns could be assessed against three criteria – whether the product's return objective was met (was the fund "true to label"?); whether the strategic asset allocation was suitable for the relevant cohort of members (are 25-year-old members in inappropriate defensive products?); and whether the product's risk profile was appropriate in achieving the return (ensure funds are not taking excessive risk in order to achieve a "pass").

APRA discretion

Giving APRA the discretion to apply a qualitative overlay to gauge the performance of a product in circumstances where it is difficult or inappropriate to apply risk measures in the assessment, or to account for material changes to the fund's strategy to address underperformance, would result in better outcomes for members. The discretion could allow APRA to, for example, consider a fund's broader investment governance arrangements in determining the test outcome and any conditions/future performance requirements.

This would likely reduce or eliminate, reactionary risk-aversion and risk-taking behaviour and would allow APRA to consider alternatives to product closure in circumstances where the product's recent performance is strong and continually improving, or where the trustee has taken all reasonable steps to improve investment performance under the test. The closure of a product that has sufficient scale, strong recent performance, and/or has delivered on its investment objectives, will almost certainly be detrimental to the members who languish in the closed product for any period while asset write downs and fire sales are occurring.

[1] As that term, or any other equivalent term, is defined from time-to-time in law or by a regulator, in line with the changing environment.

We welcome further discussion on any of the points that we have raised in this submission. Any questions in relation to this submission should be directed to Eve Brown at the contact details below.

Yours faithfully,

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