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TO: ALL RSE LICENSEES

PUTTING MEMBERS FIRST: EXPECTATIONS AND AREAS OF FOCUS FOR THE YEAR AHEAD

The release in February 2019 of the final report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the Royal Commission) was a pivotal point for the financial services sector (including the superannuation industry) – reinforcing the need to rebuild trust, strengthen governance and address misconduct. The Royal Commission highlighted specific examples where trustees did not appear to be clearly putting their members' interests first. Moreover, the Productivity Commission's *Review of Efficiency and Competitiveness of the Australian Superannuation System* pointed to deficiencies in the performance of the industry, identifying areas where sound outcomes were not being delivered for members.

As I recently noted in my speech to the Conference of Major Superannuation Funds, the APRA-regulated superannuation industry has served the majority of its members well. However, in a number of areas it lacks the maturity in its governance and risk management practices that should be expected from modern financial institutions managing billions of dollars on behalf of members.[1]

A report detailing the outcomes of APRA's post-implementation review of the superannuation prudential framework that was introduced in 2013 will be published shortly. While this review indicates that APRA's suite of prudential standards has promoted improved governance and risk management practices across the industry, there remains more to do.

Over the coming year, APRA's focus will continue to be on ensuring that all trustees are putting their members first and meeting their responsibilities under the *Superannuation Industry (Supervision) Act 1993*. In particular, we will be intensifing our focus on identifying underperforming funds to ensure timely and adequate action is taken to address areas of underperformance. We will also take steps to enhance transparency through improved data and disclosure on the industry's performance and operations, and increased visibility of APRA's actions to address underperformance.

The Attachment to this letter outlines specific areas where APRA will be focusing. It sets out some of our expectations of trustees in more detail, including areas where APRA expects them to review and, where needed, improve their performance and operations. All of these areas should be explicitly considered by trustees in the coming months, and appropriate action plans developed. Plans to address relevant recommendations of the Royal Commission directed at the superannuation industry should also be developed, in anticipation of necessary regulatory or prudential requirements being implemented.

[1] Helen Rowell, 'Opening the door to greater transparency in superannuation', Speech to Australian Institute of Superannuation Trustees' Conference of Major Superannuation Funds, 13 March 2019.

APRA has outlined its strong commitment to implementing the Royal Commission's recommendations expeditiously: there are 10 recommendations requiring APRA's direct attention and of these, nine are expected to be completed by the end of 2020. We will also be working with the Treasury, the Australian Securities and Investments Commission (ASIC) and other stakeholders to ensure other recommendations relevant to APRA, such as an extension of the Banking Executive Accountability Regime to other APRA-regulated industries, can be progressed as quickly as possible. APRA is also pursuing the specific cases referred to it by the Royal Commission and enhancing its approach to enforcement. A review of our enforcement approach will be completed by the end of this month and published shortly thereafter.

Going forward, APRA will continue to strengthen its collaboration and cooperation with ASIC on both industry-level and specific regulated entity matters. In particular, APRA expects to be working together with ASIC on specific matters where APRA and ASIC share a strong interest. Joint communication to and engagement with the superannuation industry by the two agencies will be utilised where appropriate.

All superannuation trustees – including those with strong recent financial performance – need to avoid complacency, proactively assess their practices and performance across a range of dimensions and develop strategies and plans to ensure they will continue to be able to meet their obligations to their members into the future. APRA will be ensuring this occurs through our various entity-specific and thematic supervision activities, and holding the industry to account through enhanced transparency measures.

Yours sincerely,

Helen Rowell
Deputy Chairman

Attachment: Superannuation areas of focus 2019-2020

1. Assessing and improving member outcomes

APRA's new prudential standard *SPS 515 Strategic Planning and Member Outcomes* becomes effective from January 2020. Under the new requirement to formally assess the outcomes provided to members, trustees need to develop a robust assessment process that covers all dimensions of outcomes and assesses these against a range of meaningful benchmarks. This process must be supported by a culture that values constructive self-reflection, honesty and objectivity in undertaking the assessment.

Trustees should now be drawing up plans to ensure that they will meet these requirements and be prepared to share these with their APRA supervisors. APRA will contact entities shortly with more details on our expectations in this regard and to outline how we propose to assist industry in meeting the new requirements of SPS 515. Over the coming months we will also seek to gather information that will enable us to assess industry preparedness.

APRA expects trustees to clearly articulate and measure their performance across a range of areas including but not limited to investment performance. Investment performance should be considered on a risk-adjusted basis net of investment fees, over varying time periods relevant to the fund's membership base and with reference to a range of relevant benchmarks, on a relative and absolute basis. Trustees should take a holistic approach to assessing the overall outcomes provided to members based on the products, options and services offered including how they meet the needs of members in terms of performance, risk, diversification and fees and costs. Trustees also need to assess on an ongoing basis whether their significant expenditures are consistent with the best interests of members.

In parallel to trustees conducting their own outcomes assessments, APRA will continue to target areas of persistent underperformance across the industry, in an expanded and more intensive manner. In 2017/18, APRA identified a cohort of underperforming funds with concerns across measures of net returns, fees and costs and sustainability, and has taken action to ensure these concerns are addressed.[2] We will continue to use data-driven insights to identify underperforming funds, products and options and our 'outlier' list will be regularly reviewed and updated. APRA will update and expand the analysis of underperforming funds based on metrics spanning four key areas: net investment performance; fees and costs; insurance; and scale and sustainability.

This analysis will include consideration of products beyond MySuper where reliable data is available. This area is more complex, given the broader range of asset class exposures (and hence risk and return outcomes) from different investment options. Clearly, obtaining more granular and meaningful data will be a component of this analysis as discussed further below.

APRA will use our own outcomes assessments as part of our review of those conducted by superannuation trustees under the new prudential requirements. We also intend to regularly publish our view of performance at a more granular level across the industry.

In cases where, in APRA's view, trustees are persistently underperforming, supervisors will discuss with trustees how this may be promptly addressed and whether they may need to consider a restructure or exit from the industry. APRA would use the potential stronger

[2] APRA, Letter to all RSE licensees, 'Assessing quality outcomes in the superannuation industry', 31 August 2017.

directions powers (currently pending in legislation before Parliament), where needed, to compel trustees to take appropriate action. We will also seek to provide greater transparency on our use of such formal powers where feasible.

Finally, as APRA flagged in December 2018 when SPS 515 was finalised, new legislation could, if passed, require some revisions to the prudential standard.[3] While the overall framework and core elements of the legislation are consistent with APRA's prudential standard and guidance, some details may need to be reviewed so that it appropriately reflects and aligns with the legislated assessment. APRA will release proposed revisions to the standard for consultation, if and when the legislation passes through Parliament. In the meantime, trustees' work on design of their outcomes assessment to meet the requirements of SPS 515 should continue.

2. Trustee board capabilities and culture

Both the Royal Commission and APRA's Prudential Inquiry into the Commonwealth Bank of Australia found instances where institutions' culture was not aligned to producing good customer outcomes. Some trustees did not appear to understand the importance of operating with a strong fiduciary culture and mindset. APRA has also seen instances where trustee boards do not appear to have appropriate resourcing and capabilities to consistently fulfil their obligations.

APRA expects to see trustee boards making independent and objective decisions that are demonstrably in the best interest of their members. We also expect trustees to identify and take steps to address any barriers to lifting trustee capabilities and meeting their resourcing needs. APRA supervisors will work with trustees on improving practices in these areas, including:

- being able to clearly demonstrate how the governance and mindset of the board facilitates acting in the best interests of the members;
- ensuring that the trustee board has an appropriate mix of skilled and experienced directors, who are well equipped to deliver sound outcomes for members and are able to bring sufficient independence and objectivity to decision making;
- effectively managing board renewal, including limiting excessive tenure or undue turnover, to ensure that the right capability and board stability can be maintained;
- critically assessing board performance, capability and outcomes achieved and implementing measures to address any shortfalls or weaknesses that are identified;
- avoiding or effectively managing actual or perceived conflicts of interest, particularly in dealings with related or connected persons or entities;
- conducting more robust, forward-looking and outcomes-focused business and strategic planning and risk assessment; and

[3] *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Bill 2019*.

- fully embedding a fiduciary mindset across all decision-making, including decisions about executive remuneration and fund expenditures, to ensure these are in the best interest of members and meet statutory obligations including the sole purpose test.

3. Risk governance

Minimum standards for risk management by superannuation trustees are set out in *Prudential Standard SPS 220 Risk Management,* which became effective in 2013. Given the maturity of risk functions that existed across the industry at the time, APRA did not fully align the requirements for superannuation entities in some areas with those that apply to the other financial industries that APRA regulates. However, as the industry has grown in size and sophistication since then, and taking into account the outcomes from the post implementation review of the prudential framework, APRA is considering more closely aligning some of the key requirements in SPS 220 with those in *Prudential Standard CPS 220 Risk Management.*

In particular, APRA expects that trustees for larger and more complex institutions would consider why they should not meet CPS 220 requirements in areas such as the independence and prominence of the risk function. APRA does not see any rationale for a modern and mature financial institution not to have an independent and well-resourced risk function, including a Chief Risk Officer with a direct reporting line to the CEO and regular access to the board and board risk committee.

4. Conflicts of interest

Trustees are directly accountable for meeting members' best interests regardless of corporate structures. The Government has indicated that it will adopt the Royal Commission's recommendation regarding inherently conflicted structures, such as dual regulated entities, and all trustees should now be planning for this change where relevant to them.

With respect to outsourcing arrangements, APRA is planning an in-depth review, most likely through the engagement of external experts, commencing later in 2019. This will be undertaken in stages, initially focused on a small number of larger superannuation entities with material related party arrangements. However, APRA will also gather information on the terms and costs of outsourcing arrangements across the broader population of trustees, with a view to undertaking further phases of work on outsourcing across a wider set of entities. APRA intends to publish the results of this review, and will consider how to provide greater transparency on the findings across entities covered and the assessment of their practices.

Trustees also need to ensure that there is robust assurance around any amounts charged to members on behalf of third parties (whether or not those parties are associates). APRA and ASIC will be providing a joint communication to superannuation entities on expectations for oversight and review in this area.

5. Data and reporting

Accurate and timely data plays a vital role in enhancing the superannuation industry's transparency, allowing trustees to be held accountable for the outcomes they deliver to members, helping consumers make informed decisions and ensuring all stakeholders can draw meaningful conclusions on industry performance. As the Productivity Commission noted in its recent report, there remain challenges in obtaining accurate and meaningful data from superannuation trustees in some areas. This is not acceptable given the industry's crucial role in providing retirement incomes for the Australian community.

The current set of regulatory data reported to APRA was instituted in 2014. Despite ongoing work since then to enhance its consistency and accuracy, limitations and quality of data hamper APRA's ability to effectively supervise the industry and the ability of other stakeholders to understand how the industry operates and performs. APRA is undertaking a review of the superannuation regulatory data reporting set, which aims to provide greater coverage, enhanced consistency and better quality data through clarifying and revising definitions, as well as increased granularity in some areas, such as expenses. We will particularly focus on upgrading visibility across the choice segment of the market, where the largest data gaps remain.

In developing the revised data collections, and in conducting deep dive reviews and other thematic supervision work, APRA will be issuing periodic data collection requests for trustees. APRA intends to progress these on an informal basis and expects appropriate responsiveness to these requests from trustees.

Trustees will need to invest in compiling appropriate internal and external data to perform their regular assessments of the outcomes provided to members and in anticipation of this enhanced reporting regime. Accordingly, APRA expects that trustees will be assessing and improving their own data quality and breadth, and have in place data management plans and appropriate accountabilities.

6. Accountability and remuneration

The Government has stated that it will legislate to extend the concepts of the Banking Executive Accountability Regime (BEAR) to superannuation, as recommended by the Royal Commission. Regardless of the timing and detail of that legislation, it would be prudent - and indeed a worthwhile exercise - for trustees to commence the process of developing accountability statements for themselves and their key executives.

In 2019, APRA will be updating its prudential requirements on executive remuneration. It is expected that these requirements will apply to superannuation trustees as well as banking and insurance entities. While the use of substantial variable remuneration is not as widespread in the superannuation industry, APRA nevertheless expects to see that where performance-based remuneration is used, it is truly performance-based and takes into account risk, long-term financial soundness and outcomes for members. Where misconduct or conduct not in members' best interests has been identified, APRA expects to see remuneration outcomes for accountable executives adjusted accordingly.

7. Sole Purpose Test

The industry has previously noted that there is ambiguity around the intent of the sole purpose test, which has contributed to differing interpretations and practices within the industry. Some examples of questionable practices in this area were also highlighted by the Royal Commission.

APRA indicated in December 2018 that it would be updating its guidance on the sole purpose test during 2019.[4] Given the questions that have arisen about the appropriate range of activities that fall within the sole purpose test, and its importance in determining the boundaries of practices that may be regarded as acting in the best interests of members, APRA intends

[4] APRA, *Response to Submissions: Strengthening Superannuation Member Outcomes*, December 2018.

to undertake a review, involving ASIC as appropriate, of particular cases or circumstances where compliance with the sole purpose test has been called into question. The aim of this review will be to develop clear principles to inform updated guidance and its implementation, as well as identifying potential breaches where appropriate action should be taken. The review may also lead to recommendations as to whether the law could be clarified to better meet the intent of the sole purpose test.

8. Insurance and inactive accounts

The trustee covenants set out in the *Superannuation Industry (Supervision) Act 1993* require trustees to only offer insurance if the cost does not inappropriately erode the retirement income of beneficiaries. The Productivity Commission's report highlighted the significant detriment that can occur when members hold unnecessary, duplicate or multiple sets of insurance cover.

To comply with the covenants, and as part of meeting the member outcome assessment requirements, trustees must therefore regularly review and undertake an assessment of their insurance arrangements. This would include whether the insurance cover they provide to members is in their best interests and is providing appropriate outcomes, considering trade-offs between coverage, design, terms and conditions and premiums, across different demographic cohorts.

The recently passed *Protecting Your Super* legislation requires trustees, among other things, to cease default or 'opt-out' insurance cover, where the member's account has been inactive for a period of 16 months or more.[5] Implementing this requirement will require potentially significant operational activities and member communications that trustees need to be actioning immediately. Trustees should also be proactively considering what further implementation steps may be needed should the pending legislation that would change insurance requirements for members under age 25 be passed by Parliament.

APRA has incorporated the Royal Commission recommendations relating to insurance into its policy agenda for 2019. In particular, the Royal Commission recommended that APRA require RSE licensees that engage a related party to deliver group life insurance, to provide APRA with independent certification that the related party arrangement is in the best interests of members.[6] APRA will consult on the necessary changes to its prudential standard and guidance to implement this recommendation later in 2019, in conjunction with consultation on other changes to the prudential framework. In the meantime, it would be good practice for trustees for which this recommendation is applicable to commission such a review as soon as practical.

The Royal Commission also recommended that APRA should amend its prudential standard on insurance to require RSE licensees to review their approach to attributing certain status to members under life insurance policies.[7] APRA will also action this recommendation. In the meantime, APRA expects trustees to take steps to ensure that practices in relation to attributing particular status to members for insurance purposes are appropriate and likely to meet community expectations.

The new requirements for the consolidation of inactive accounts will also have a material impact on a number of funds. APRA expects trustees to proactively assess the impact on their

[5] *Treasury Laws Amendment (Protecting Your Superannuation Package) Bill 2018*.
[6] Royal Commission recommendation 4.14.
[7] Royal Commission recommendation 4.15.

members and their overall business operations, strategy and sustainability. The change will have a particularly large impact on Eligible Rollover Funds (ERFs) and APRA will be engaging with those entities shortly to outline our position on the impact the changes will have on ERFs and the step that ERF trustees must take to ensure that members' interests are protected.