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Contents

Superannuation industry overview

This article provides an update on the financial position and performance of the superannuation industry over 2012/13. It also discusses APRA's views on the key risks and issues facing the industry as it continues to implement and embed the recent superannuation reforms.

Introduction

The superannuation industry delivered solid growth over 2012/13. This growth was underpinned by a combination of strong investment performance, achieved amid a patchy economic backdrop, and a steady inflow of contributions.

Over the year, the industry continued to experience structural changes associated with the transition of assets and members to the post-retirement phase, consolidation activity and migration of large balances from the APRA-regulated sector to self-managed superannuation funds (SMSFs).

The Stronger Super reforms largely took effect from 1 July 2013, driving significant changes in many areas of operations of registrable superannuation entity (RSE) licensees. APRA's focus has now moved towards ensuring effective industry implementation of the new superannuation prudential standards, one of the main elements of the reforms. APRA is also looking to RSE licensees to make the necessary behavioural and operational changes to embed the reforms into their day-to-day operations.

Overview of the superannuation industry

Superannuation assets

Over 2012/13, the value of total superannuation assets increased by 15.7 per cent to $1.6 trillion, equivalent to 106 per cent of Australia's Gross Domestic Product (GDP) (Figure 1).

This is the highest annual rate of growth in superannuation assets since the global financial crisis began. The growth was underpinned by a combination of strong overall investment performance and continued inflows from contributions.

The rally in global and domestic equity markets, although hesitant in the second half of 2012/13, produced double-digit returns on an industry-wide basis for 2012/13. This strong performance saw total superannuation assets rise to $1.8 trillion as at 31 December 2013.

Future growth in total superannuation assets will be driven by the planned increase in the rate of the compulsory Superannuation Guarantee (SG)[1], investment performance and the manner and rate in which benefits are drawn from the system as the population ages.

Asset allocation

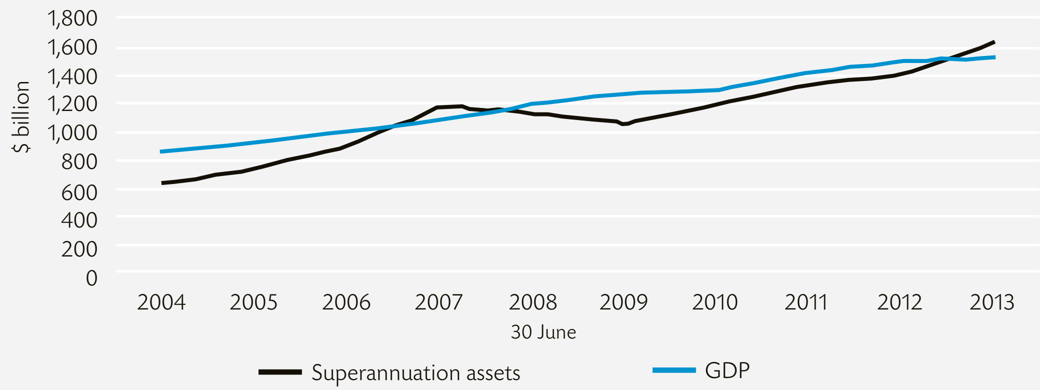
As at 30 June 2013, 43.7 per cent of total assets held by superannuation entities[2] with more than four members were held in a default investment strategy (Figure 2), a slight increase over the previous year.

Industry and public sector funds held the highest proportion of assets in the default investment strategy, at 67.2 per cent and 53.6 per cent, respectively. Corporate funds held 46.9 per cent of assets in the default strategy and retail funds held 19.3 per cent.

1 The Coalition Government has announced its plans to change the schedule for increasing the Superannuation Guarantee (SG) rate to 12 per cent. The Government will continue to increase the SG rate to 12 per cent from 9.25 per cent, but the changes will take place over a different timeframe. Instead of pausing at 9.25 per cent as previously announced, the SG rate will now increase to 9.5 per cent on 1 July 2014 and will remain at this level until 30 June 2018. It will then increase by 0.5 per cent each year until it reaches 12 per cent in 2022-23, one year later than previously proposed

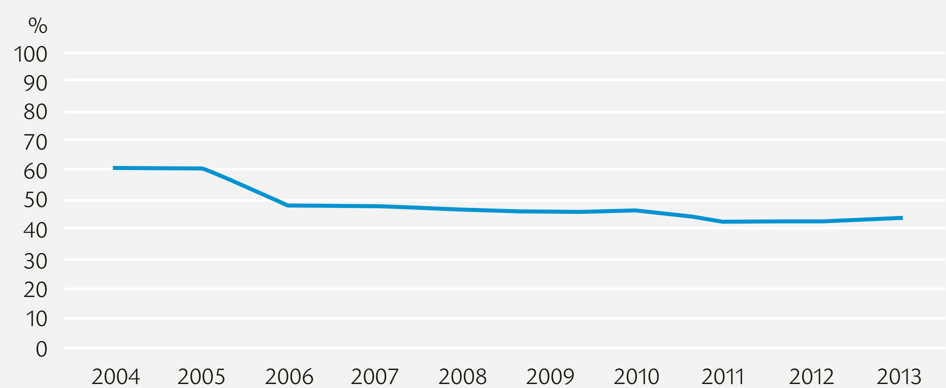
2 'Superannuation entities' refer to APRA-regulated entities with more than four members and exempt public sector superannuation funds.

Figure 1: Total growth of superannuation assets and nominal GDP



Source: APRA *Annual Superannuation Bulletin* and ABS Statistics

Figure 2: Default strategy assets as a proportion of total assets*



* Entities with more than four members

Source: 2013 and previous editions of APRA *Annual Superannuation Bulletin*

There were no significant changes in the allocation of investments within the default strategy of superannuation entities with more than four members over 2012/13 (Figure 3).

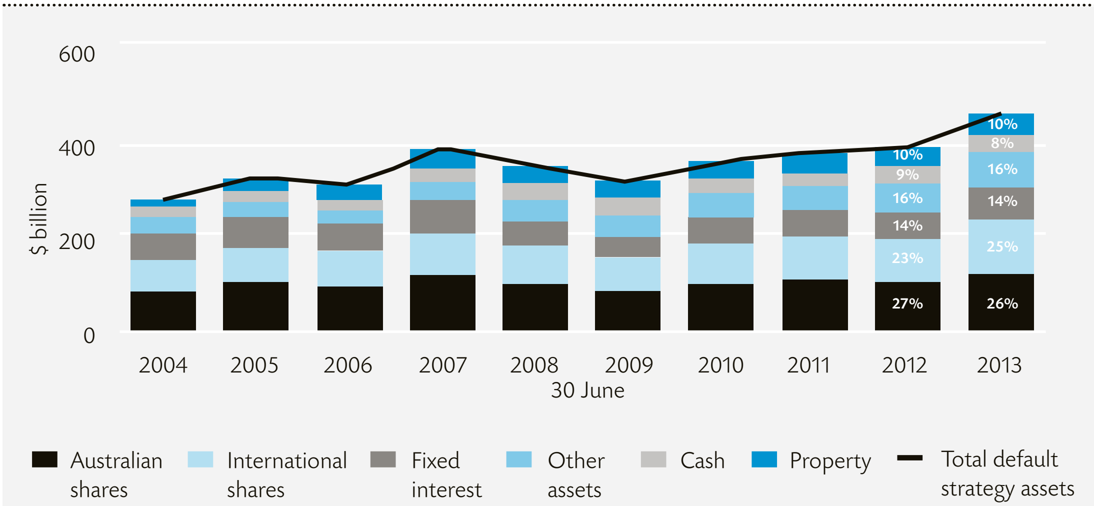
Australian and international equities continued to dominate the portfolios of default funds. There has been evidence of growing demand for offshore investments among larger funds that continue to seek better investment opportunities and diversification of sources of risk and return.

APRA has also observed an increase in the use of dynamic asset allocation strategies by RSE licensees in response to market volatility. Adopting a dynamic asset allocation requires RSE licensees to have a strong governance process that is well understood and supported by the board, a robust valuation framework and a rigorous decision-making process that focuses on achieving long-term investment objectives rather than short-term returns. RSE licensees also need to have adequate resources and expertise to implement these strategies.

The proportion of assets invested directly has continued to rise. As at 30 June 2013, 45.9 per cent of assets were invested directly, an increase from 45 per cent in 2012. Of the remainder, 40.3 per cent were placed with investment managers and 13.8 per cent were invested in life office statutory funds (Figure 4).

Greater consideration has been given to in-sourcing of investment management functions by RSE licensees, to reduce costs associated with investment management and obtain greater control over investments. APRA's view is that RSE licensees that choose to bring investments in-house should not be driven primarily by cost considerations and should ensure that they have sufficient scale and expertise and the robust risk management framework required to effectively undertake in-house asset management.

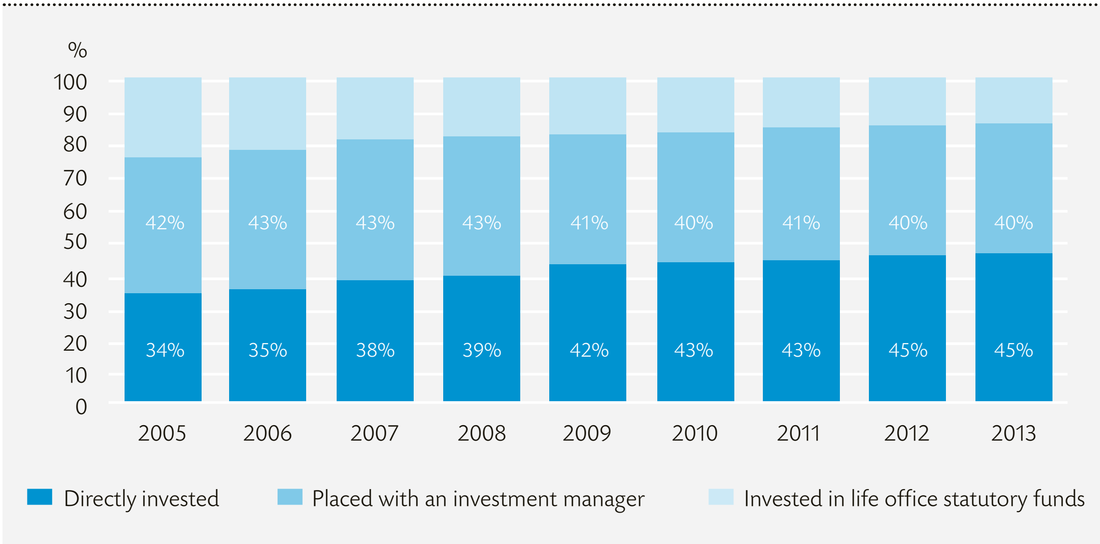
Figure 3: Default asset allocations*



* Entities with more than four members

Source: 2013 and previous editions of APRA *Annual Superannuation Bulletin*

Figure 4: Manner of investment



Source: APRA *Annual Superannuation Bulletin* 2013, Table 14

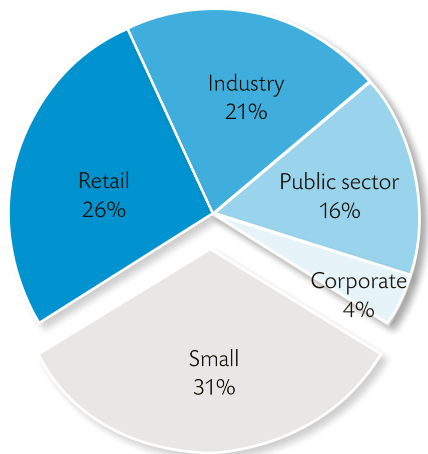
Industry structure

Industry segmentation

The trends evident for a number of years in the market shares of differing segments of the industry continued in 2012/13 (Figure 5).

Growth of SMSFs slowed slightly over 2012/13; however, they remained the single largest sector, accounting for 31.3 per cent of total industry assets as at 30 June 2013. The retail fund sector was the second largest sector, comprising 26.1 per cent of total industry assets at that date. With one-fifth of total industry assets, the industry funds sector remained the second fastest growing sector, and the only APRA-regulated sector that increased its market share over the decade. Public sector and corporate funds represented 15.9 and 3.8 per cent of total industry assets, respectively.

Figure 5: Industry segmentation by assets as at 30 June 2013



Source: APRA *Annual Superannuation Bulletin* 2013, Highlights

Structure of retirement benefits

There has been a continuing, albeit relatively slow, contraction in the proportion of retirement benefits that are defined benefit (rather than accumulation) over a number of years. For example, the proportion of assets supporting accumulation benefits of superannuation entities with more than four members increased from 82.7 per cent to 83.6 per cent over 2012/13 (Figure 6). This trend is expected to continue as most defined benefit funds are closed to new members.

The financial position of many defined benefit funds improved over 2012/13, particularly due to the stronger performance of equity markets. However, prolonged low interest rates and the risk of rising unemployment will require continued close oversight of the financial position of these funds by RSE licensees.

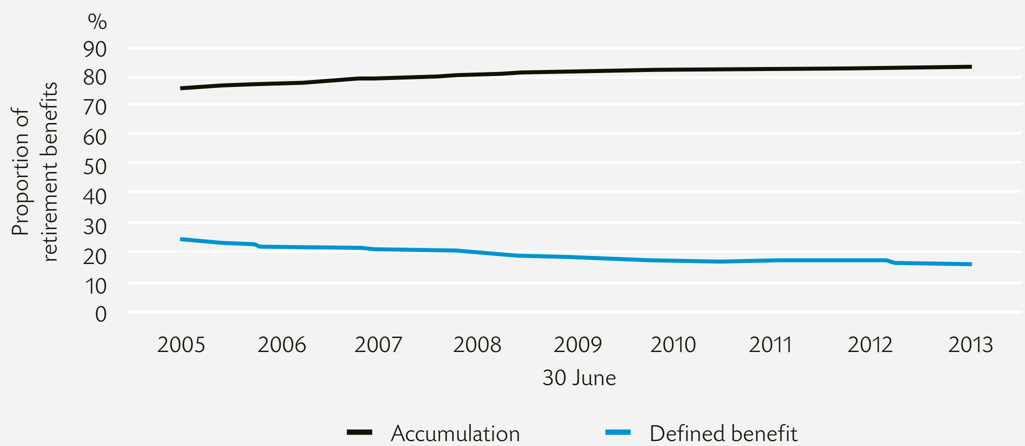
Number of RSE licensees and funds

Consolidation of the industry continued but at a slower pace than seen in the previous few years. The number of RSE licensees reduced by 19, to 190, over 2012/13 before declining further to 179 as at 31 December 2013.

The number of APRA-regulated funds with more than four members declined by 28, from 333 to 305 entities over 2012/13 (Figure 7). This number fell further to 290 entities by 31 December 2013.

The largest decline in the number of funds was in the corporate funds sector as companies closed their funds and moved members and assets into master trusts offered by retail providers and industry funds. Industry and retail fund sectors also reported a decline in the population of their funds due to ongoing mergers of entities between and within these sectors.

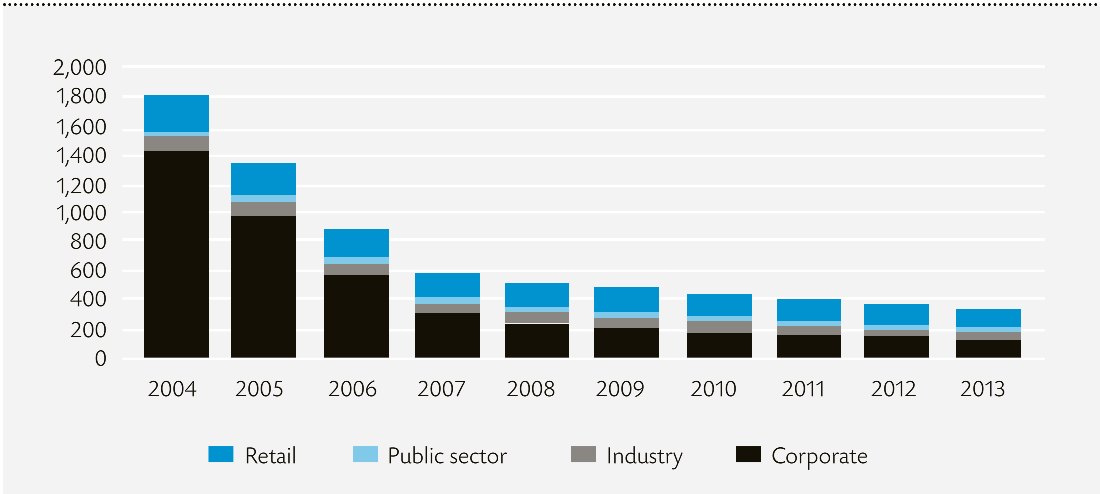
Figure 6: Structure of retirement benefits*



* Entities with more than four members

Source: APRA *Annual Superannuation Bulletin* 2013, Table 16

Figure 7: Number of APRA-regulated funds with more than four members



Source: APRA *Annual Superannuation Bulletin* 2013, Table 1

As at 30 June 2013, the largest 20 funds (measured by total assets) comprised 10 retail, six industry, three public sector and one corporate fund. Combined, these funds accounted for 58.1 per cent of the total assets and 54.5 per cent of the total membership of APRA-regulated funds with more than four members (Appendix 1).

Merger activity over the last couple of years slowed a little, in part due to RSE licensees' attention being focussed on other areas such as implementation of the Stronger Super reforms and Future of Financial Advice (FOFA) requirements. Attention is likely to return to costs and scale in the post-reform environment and this may provide a renewed incentive for funds to consider merger opportunities.

Mergers can expose significant weaknesses in data quality and give rise to conflicts of interest, among other risks. Poorly planned and executed mergers can result in a lack of cultural alignment and synergy benefits and ultimately detract from the value to members. RSE licensees that contemplate mergers need to ensure that they adequately understand and address these risks and look to engage with APRA early in the process.

Member accounts

The total number of member accounts declined by 3.4 per cent from 31.8 to 30.7 million over 2012/13.

The largest decline was in the retail funds sector where the number of member accounts decreased by 939,000 (6.1 per cent). Member accounts for industry funds decreased by 140,000 (1.2 per cent), for corporate funds by 38,000 (6.9 per cent) and for public sector funds by 35,000 (1.0 per cent). By contrast, the number of accounts in the SMSF sector increased by 64,000 (7.1 per cent).

The decline in member accounts in the APRA-regulated sector was largely driven by the increase in the threshold for unclaimed and lost superannuation accounts that were to be transferred to the Australian Tax Office (ATO) in 2012/13.[3]

While there have not been any significant liquidity problems resulting from these outflows, liquidity management remains an important focus for RSE licensees and will continue to receive attention from APRA in its supervison activities.

3 *Superannuation (Unclaimed Money and Lost Members) Act 1999*.

Member flows

Net contribution flows

Net contributions flows declined by 11.1 per cent to $46.8 billion over 2012/13 (Figure 8).

The decline can be attributed to the combined effects of lower total contributionsand an increase in total benefit payments in 2012/13 compared to 2011/12.

While the industry as a whole remained cash flow positive, the ratio of withdrawals to contributions has continued to rise. Over 2012/13, net contributions declined for retail and public sector RSEs, compared to 2011/12, and corporate funds continued to experience a net outflow.

Contributions

Total contributions declined by 2.1 per cent to $115.3 billion over 2012/13, primarily due to a one-off contribution into SAS Trustee Corporation – Pooled Fund in the previous financial year.[4] Overall, contributions have proven to be resilient over the years and are expected to grow, in line with the planned increases in the mandatory SG contribution rate.

Benefit payments

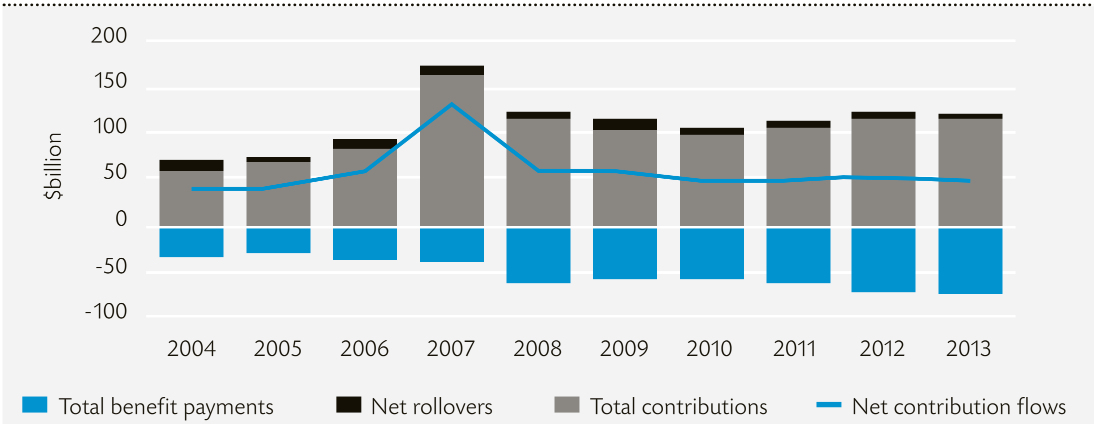
Total benefit payments increased by 4.7 per cent to $74.5 billion in 2012/13. The largest outflow of benefit payments was experienced by retail and public sector funds. The proportion of benefits taken in the form of pensions[5] continued to increase and benefits taken as lump sums continued to fall (Figure 9).

Benefit payments will continue to rise naturally as the system matures and further growth in the value of pension payments can be expected in line with the increase in retirement-age vested benefits.

4 During the year ending June 2012, SAS Trustee Corporation - Pooled Fund, an exempt public sector superannuation scheme, received an additional $4.6 billion of employer contributions from the employer sponsor, resulting in higher public sector funds' employer contributions in the year ending June 2012 ($27.8 billion).

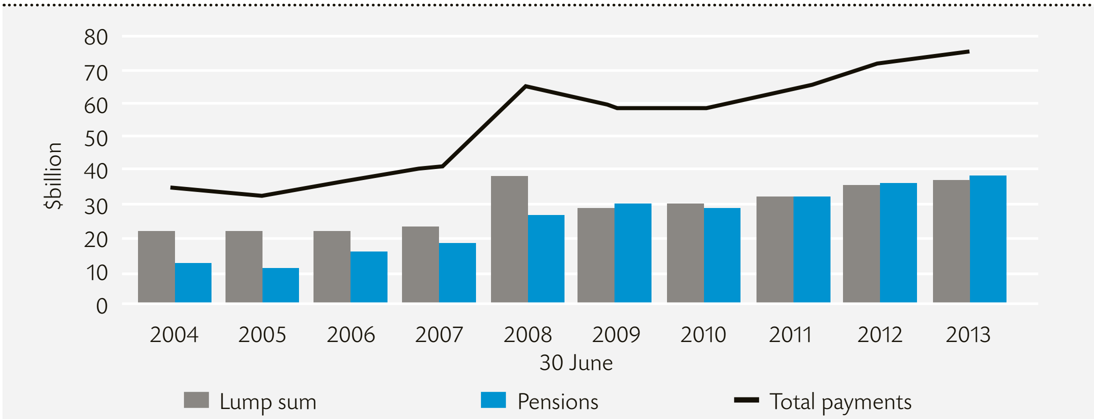
5 For APRA-regulated funds with more than four members.

Figure 8: Net contribution flows



Source: APRA *Annual Superannuation Bulletin* 2013, Table 7

Figure 9: Benefit payments



Source: APRA *Annual Superannuation Bulletin* 2013, Table 7

Net rollovers

Net rollovers from the APRA-regulated sector have been negative in most years since 2008 (Figure 10). This reflects continued 'leakage' of large balances to the SMSF sector and, more recently, transfers of small inactive accounts to the ATO.

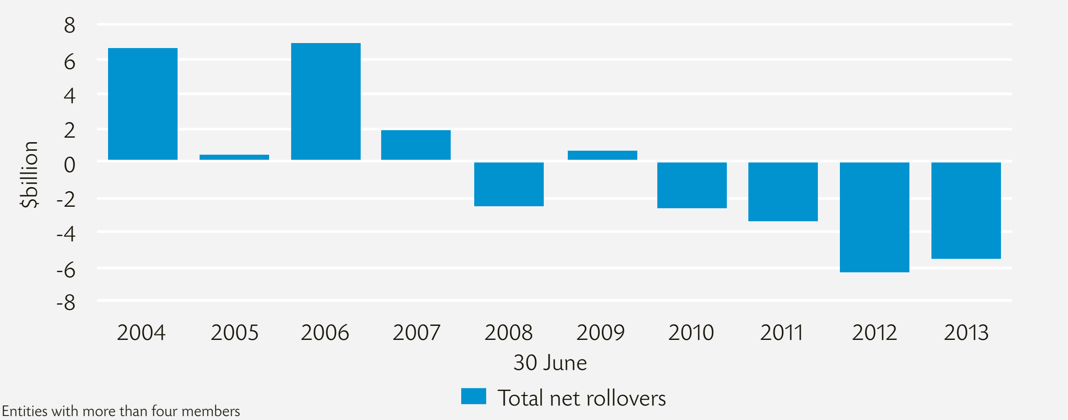
Although the volume of outflows fell in 2012/13, prudent liquidity management by RSE licensees that have been experiencing these outflows remains important, as noted earlier.

Membership profile

The membership profile of superannuation funds in Australia has continued to age. As at 30 June 2013, members aged 60 and over held 10.9 per cent of total accounts and 33 per cent of total vested benefits (Figure 11).

Members aged between 50 and 59 also held a significant proportion (30 per cent) of vested benefits, with the remaining 37 per cent accounted for by members aged under 50. This highlights the fact that an increasing proportion of members are approaching retirement age. Hence, funds need to consider what post-retirement products or options it may be appropriate to provide, including appropriate education and advice to assist members in their transition to the post-retirement phase.

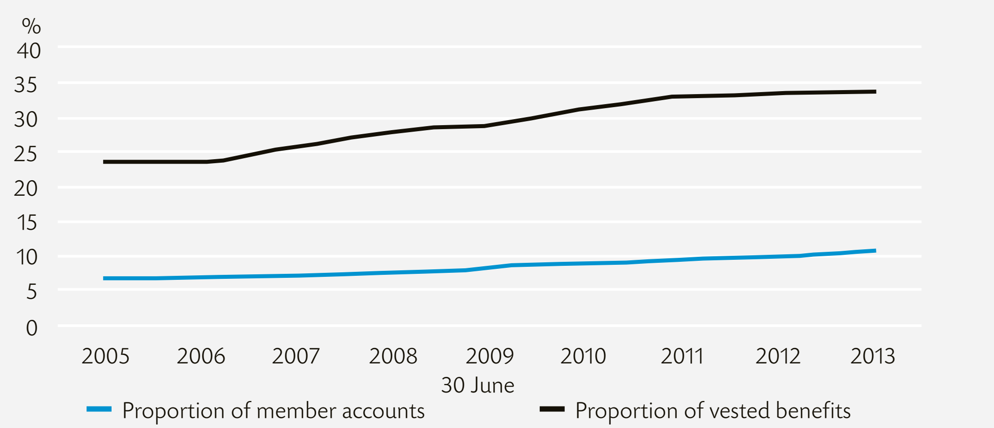
Figure 10: Net rollovers*



* Entities with more than four members

Source: 2013 and previous editions of APRA *Annual Superannuation Bulletin*

Figure 11: Superannuation members aged 60 and over*



* Entities with more than four members

Source: 2013 and previous editions of APRA *Annual Superannuation Bulletin*

Stronger Super reforms

The final pieces of legislation to complete the Stronger Super reforms were passed by Parliament in the last few days before 1 July 2013. The new prudential regime gave APRA the power to issue prudential standards and enabled RSE licensees to apply to APRA for authorisation to offer MySuper products. APRA has also revised superannuation reporting obligations to enhance industry transparency and support implementation of the new prudential standards and MySuper requirements.

APRA released a suite of final prudential and reporting standards and guidance for superannuation by the end of 2013. Selected reporting standards are currently undergoing further review. Between 1 January 2013 and 31 December 2013, APRA authorised 115 MySuper products and also issued authorisations to eight RSE licensees to operate an Eligible Rollover Fund (ERF) from 1 January 2014.

In addition, the legislation and supporting regulations that establish data and payment standards for contributions and rollovers under the SuperStream reforms have begun to take effect. The SuperStream standards for rollovers commenced on 1 July 2013 and the standards for contributions from employers come into effect from 1 July 2014, subject to transitional arrangements extending to 1 July 2015.

MySuper

For MySuper, APRA's supervision focus in the coming year will be on ensuring the compliance of RSE licensees with statutory requirements relating to product characteristics, the structure of permitted fees and the fulfilment of enhanced trustee obligations. Proposed activities in these areas are discussed in more detail in the *MySuper Authorisation* article in this edition of *Insight*.

Prudential standards

APRA has been pleased with the industry's progress to date towards meeting the requirements under the new prudential standards, with most of the industry having already put in place the required framework and policy architecture. However, more work is needed to effectively implement and embed these new or revised policies. This applies across a number of areas covered by the prudential standards, such as risk appetite and risk management, investments, insurance, and conflicts management. APRA will be undertaking thematic reviews in targeted areas to assess industry's progress on implementation. APRA will provide feedback based on these reviews to highlight what it sees as better practices and areas where improvement is needed.

SuperStream

Industry has been implementing the changes necessary to facilitate rollover processing under SuperStream. A number of RSE licensees were granted delayed transitioning-in completion dates to comply with the SuperStream rollover obligations. However, the implementation of SuperStream contribution requirements under the superannuation data and payment standards continues to pose challenges for the industry. A number of concerns continue to be raised by stakeholders, including software solution implementation, gateway governance and employer engagement and communications.

APRA's focus in relation to new SuperStream will be on the following three key areas:

- outsourcing and the use of gateway providers;
- strategies to manage and enhance data integrity; and
- implications for the operational risk financial requirement (ORFR).

APRA expects RSE licensees to determine whether the elements of contributions and rollovers processing conducted by their gateway provider are material and hence should be managed in line with the requirements of *Prudential Standard SPS 231 Outsourcing*.

APRA will be reviewing the manner in which operational risk events that may arise from the use of gateways are considered in risk management frameworks of RSE licensees and how they are reflected in the assessment of the operational risk profile of an RSE licensee, its ORFR strategy and the established target ORFR amount.

Data integrity need to be front of mind for RSE licensees tendering for services, particularly administration and insurance, with a focus on sustainable pricing that supports adequate management of data.

Key supervisory issues

In the current environment there are many risks and issues facing RSE licensees and the superannuation industry as a whole. This section summarises some of the key supervisory issues that are receiving heightened attention from APRA and will continue to do so over the next 12 months or more.

Data integrity

Data integrity is considered by APRA to be a significant risk for the industry. More recently, this risk has been manifesting itself in particular in poor management of insurance data. APRA has continued to stress to RSE licensees the importance of data integrity and robust data management in meeting their obligations to members.

Overall, there remains significant room for improvement in industry's data management practices. Improvements are expected to flow from the data quality requirements embedded in SuperStream; however, it may be some time before these improvements are evident. APRA expects that, once fully implemented, the new data collection and reporting requirements will provide enhanced insight into the quality of data across the industry and lead to further improvements in data integrity.

Data integrity needs to be front of mind for RSE licensees tendering for services, particularly administration and insurance, with a focus on sustainable pricing that supports adequate management of data.

The approach of RSE licensees to the management of data will form an important part of APRA's supervisory activities in the coming year. APRA will be looking for a comprehensive response to data quality issues that are identified, evidence of regular reporting to the board on performance against data Key Performance Indicators (KPIs) and regular reviews of the data being maintained by service providers.

Insurance in superannuation

Insurance is another key area of focus for APRA. APRA is concerned about a range of issues that impact on both the superannuation and life insurance industries, including past pricing levels, the approach to tenders in the group life insurance market and the management of insurance data. *Prudential Standard SPS 250 Insurance in Superannuation* places strong emphasis on the role of RSE licensees (and insurers) in these areas. APRA is seeking to promote a sustainable approach to the provision of insurance to fund members and the development and implementation of sound insurance management frameworks. Importantly, insurer selection should not be primarily price driven and the contractual terms of the arrangement need to be sustainable and appropriate for both parties. Further, RSE licensees need to carefully consider the trade-off between the costs of insurance and retirement income objectives and how this is managed.

Governance and conflicts of interest

Management of conflicts of interest and duty is a third area of ongoing attention for APRA. Conflicts registers reviewed by APRA have been of varying quality, and widely differing approaches have been taken by RSE licensees in determining what would be considered to be a 'relevant' interest or duty. APRA expects perceived and potential conflicts, as well as actual conflicts, to be considered in board deliberations, with boards being able to justify a decision to not include a relevant duty or interest on their registers.

APRA expects to see a sound level of understanding from all directors, and evidence that they approach their role with an independent, challenging and probing mind.

Identification and management of conflicts should be a particular consideration where directors have roles on more than one RSE licensee board, or on the boards of service providers or investee companies. Boards need to assess the extent to which these relationships involve, or may be perceived to involve, conflicts and determine how such relationships are managed and reported, having regard to members' best interests. As the industry evolves and competition increases, APRA expects that it will become more difficult for these conflicts to remain manageable. Further, such conflicts are often managed by the relevant director abstaining from involvement in particular issues. Boards need to consider whether frequent abstention by a director from critical decisions due to a conflict has the potential to affect their ability to maintain a quorum and operate effectively.

APRA will be pursuing more frequent dialogue with boards and management than may have been the case in the past and wants this dialogue to be open and constructive. APRA expects to see a sound level of understanding from all directors, and evidence that they approach their role with an independent, challenging and probing mind. There should be a robust level of discussion by boards and board committees on issues, leading to soundly based decisions.

APRA expects strong skills and capabilities, and a professional approach by those operating within the industry, commensurate with their role in what are increasingly larger and more complex financial services operations. Boards need to demonstrate that they possess requisite skills and expertise, both individually and collectively, to enable them to effectively undertake their roles as fiduciaries in this increasingly complex environment. Boards also should ensure that the information being provided to them is at the right level and is focused on the right issues to support their decision-making.

APRA will also be assessing the effectiveness of board renewal policies and board performance assessment processes, and whether there is evidence of robust and transparent appointment processes as required by *Prudential Standard SPS 510 Governance.*

Liquidity

APRA's expectations of the industry in respect of liquidity risk management have increased with the introduction of *Prudential Standard SPS 530 Investment Governance.* This standard requires RSE licensees to have a liquidity management plan that outlines procedures for measuring and monitoring liquidity on an ongoing basis. In formulating such a plan, RSE licensees must consider how liquidity would be managed in a range of stress scenarios and the actions to be taken in response to adverse liquidity events. APRA will be engaging with the industry to assess the standard of RSE licensees' practice in relation to management of liquidity, particularly in the area of liquidity stress testing.

Risk management

The bar has also been raised in relation to risk governance and risk management in the superannuation industry. *Prudential Standard SPS 220 Risk Management* requires boards to have robust risk management frameworks that are adequately implemented. In particular, boards are expected to set and articulate their risk appetite and risk tolerance and monitor compliance with their risk management framework. It is important that boards have a clear view on the degree of risk that is acceptable for members and take prompt and appropriate action where risks exceed the approved limits.

...boards are expected to set and articulate their risk appetite and risk tolerance and monitor compliance with their risk management framework.

APRA will continue to challenge boards to enhance their approaches to risk management. APRA will also be looking for evidence of a sound risk culture that extends beyond a mere compliance approach, and that the board is proactive in promoting this culture. While good progress has been made by the industry in some areas, significant work lies ahead in order to lift industry risk management practices to where they need to be given the size, nature and complexity of the industry and its important role in retirement income provision.

Conclusion

The superannuation industry performed well financially over 2012/13, with strong growth underpinned by a combination of improved investment performance and continuing steady inflow of contributions.

RSE licensees have been focused on implementing a range of major policy reforms over 2012/13, including the Stronger Super and FOFA reforms. This has placed some strain on funds as they have worked to develop and update their frameworks, policies, procedures and systems to meet these new requirements.

APRA has been working with funds to facilitate the transition to the new prudential standards and prudential practice guides and has consulted widely on new reporting proposals. The progress made by the industry to date is pleasing.

Ensuring the effective implementation and embedding of the recent reforms will be the primary focus of APRA's supervisory activities in 2014 and beyond. APRA is encouraging higher standards of practice across all aspects of the industry's operations and activities, but particularly in the key areas of data integrity and management, insurance management practices, and the management of conflicts of interest. Industry's readiness for implementation of the remaining elements of SuperStream and APRA's enhanced reporting obligations will also be an area of focus.

APRA will continue to work closely with the industry to ensure that it delivers on its obligations to members through this period of substantial change.

Dina Phillips
Principal Industry Analyst (Superannuation)
Industry Analysis

Appendix 1

Top 20 funds by asset size at 30 June 2013[6]

Rank		Type	Public offer	Assets ($billion)		Members	
				June 2012	June 2013	June 2012	June 2013
1	AustralianSuper	Industry	Y	47.8	66.0	1,901,653	2,050,275
2	AMP Superannuation Savings Trust	Retail	Y	51.9	58.3	2,858,947	2,730,663
3	Colonial First State FirstChoice Superannuation Trust	Retail	Y	43.2	51.3	726,371	757,576
4	State Public Sector Superannuation Scheme	Public	N	43.5	44.5	548,560	534,757
5	Retirement Wrap	Retail	Y	34.2	41.3	623,368	725,319
6	First State Superannuation Scheme	Public	Y	34.0	40.4	755,293	772,224
7	Unisuper	Industry	N	32.6	38.7	471,673	456,191
8	The Universal Super Scheme	Retail	Y	33.9	37.7	1,271,516	1,171,162
9	OnePath Masterfund	Retail	Y	26.1	29.2	958,365	892,025
10	Retail Employees Superannuation Trust	Industry	Y	22.6	28.2	2,016,874	2,021,023
11	Sunsuper Superannuation Fund	Industry	Y	20.2	24.6	1,162,621	1,139,935
12	Health Employees Superannuation Trust Australia	Industry	Y	19.8	24.1	754,386	766,894
13	Construction & Building Unions Superannuation	Industry	Y	18.9	23.0	691,582	701,432
14	Wealth Personal Superannuation and Pension Fund	Retail	Y	14.0	17.5	119,991	129,366
15	ASGARD Independence Plan Division Two	Retail	Y	15.8	17.5	316,106	305,221
16	Mercer Super Trust	Retail	Y	15.7	17.3	242,264	237,845
17	Telstra Superannuation Scheme	Corporate	Y	12.4	15.1	104,667	104,651
18	Public Sector Superannuation Scheme	Public	N	13.0	15.0	237,492	234,764
19	MLC Superannuation Fund	Retail	Y	13.2	14.6	90,514	88,831
20	IOOF Portfolio Service Superannuation Fund	Retail	Y	12.9	14.5	414,281	389,457
				525.6	**618.9**	**16,266,524**	**16,209,611**

6 Excludes exempt public sector schemes.

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MySuper authorisation

This article provides an overview of the implementation and authorisation process for MySuper products, some of the key issues that arose during the process and the focus areas for APRA's future supervision activity.

Introduction

A new default superannuation product – referred to as MySuper - was proposed by the Government in September 2011 as a simple and cost-effective superannuation product to replace existing default products. The *Superannuation Industry (Supervision) Act 1993* (SIS Act) was amended in November 2012 to require registrable superannuation entity (RSE) licensees to seek authorisation from APRA if they intended to offer a MySuper product. The SIS Act also set out specific features for MySuper products to facilitate simplicity, transparency and comparability.

In May 2012, APRA commenced consultation with industry on the framework and process for authorising MySuper products, including the application form, instructions and *Prudential Standard SPS 410 MySuper Transition* (SPS 410). The MySuper authorisation package built on APRA's proposed prudential standards for superannuation (which were finalised in 2013) and sought submission of some of the documents that were to be established under the prudential standards. The final versions of the authorisation package and SPS 410 were released on 12 December 2012.

The development and implementation process for MySuper was a significant undertaking for APRA in terms of the resources required and the increased level of supervisory involvement during the authorisation process. Compliance with the requirements for MySuper products was also a significant undertaking for RSE licensees, as they had to address the express legislative requirement for those offering MySuper products to promote the financial interests of the MySuper members, meet the enhanced trustee obligations for MySuper products, and meet the relevant superannuation prudential standards that were introduced with effect from 1 July 2013.

The authorisation process

APRA started to receive applications for MySuper products on 1 January 2013. MySuper products could be offered by funds from 1 July 2013. From 1 January 2014, all default superannuation contributions were required to be paid into MySuper products.[1]

APRA had authorised 47 MySuper products by 1 July 2013 and 117 by 31 January 2014. The number of MySuper products authorised by APRA is far fewer than originally envisaged by APRA and the industry. This reflects, in large part, a significant reduction in the number of applications for large employer exemptions following amendments to the SIS Act to allow greater flexibility in product offerings, particularly in relation to insurance.

1 Subsection 29WA (2) of the SIS Act states that the trustee, or trustees, of the fund must treat any contribution to the fund in relation to which no direction has been given, and any part of a contribution to the fund in relation to which no direction has been given, as a contribution to be paid into a MySuper product of the fund. It applies to contributions made to a regulated superannuation fund on or after 1 January 2014: see item 13, Part 2, Schedule 1 of the *Superannuation Legislation Amendment (MySuper Core Provisions) Act 2012.*

Throughout the authorisation process, APRA reviewed and provided feedback to industry on draft applications and draft policies in order to facilitate better outcomes when final applications were received. APRA also conducted detailed reviews of the applications and engaged regularly with RSE licensees during the authorisation process. As many of the issues discussed were common across a number of RSE licensees, APRA developed frequently asked questions (FAQs) with APRA's response, which were published by APRA on its website to assist applicants.

Consistent with the SIS Act requirements, the focus of the assessment undertaken by APRA was on whether the RSE licensee was likely to comply with the rules and obligations for offering a MySuper product and, in particular, the enhanced trustee obligations that had been included in the SIS Act in relation to MySuper products. The assessment process included consideration of the responses to the information sought in the application, any additional information that was sought by APRA and the materiality of any perceived deficiencies in policies, procedures and strategies provided by the applicant in relation to the MySuper requirements. Consideration was also given to the applicant's supervision history with APRA. The assessment of applications was primarily undertaken by APRA supervisors. However, a centralised internal review process was also undertaken to ensure consistency in the approach and outcomes.

No final applications for authorisation of a MySuper product have been rejected by APRA (as of May 2014). Nearly all applicants were, however, required to provide further information as part of the authorisation process. Further, in line with APRA's consultative approach, a significant number of applicants decided to withdraw, revise and re-submit their applications based on feedback from APRA on deficiencies in their applications. Whilst almost all withdrawn applications resulted in new applications that were authorised, some applicants chose not to re-apply.

The number of MySuper products authorised to date, by fund type is shown in Figure1.

Features of MySuper products

MySuper products must comply with a set of features specified in the legislation and regulations, including:

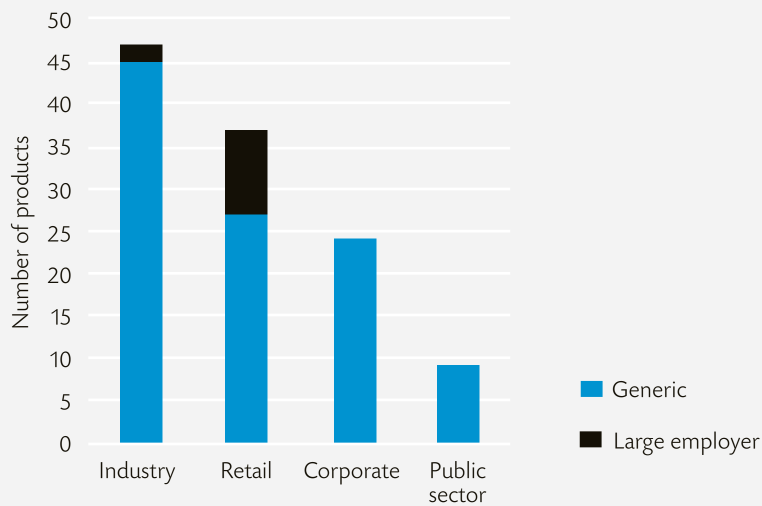
- a single diversified investment strategy;
- uniform benefits, such as access to call centres, member education, intra-fund advice and on-line account information;
- a minimum level of insurance cover;
- a prescribed list of allowable fee types;
- restrictions on how advice is provided and paid for; and
- fund governance and transparency requirements.

In offering a MySuper product, an RSE licensee is obliged to act fairly in dealing with its members, give priority to the interests of beneficiaries if there is a conflict of interests and promote the financial interests of members. RSE licensees are also obliged to determine, on an annual basis, whether the financial interests of their MySuper members are disadvantaged compared to members of other MySuper products due to insufficient scale in terms of members or assets.

While default employer superannuation contributions must be allocated to an APRA-authorised MySuper product[2] from 1 January 2014, it is not compulsory for an employee to use a MySuper product and it is not compulsory for an RSE licensee to offer a MySuper product.

2 If such contributions are made by or on behalf of members who did not have a chosen fund or did not elect to have contributions paid to a specified choice product or products.

Figure 1: MySuper products authorised by APRA by fund type.



Source: Information received by APRA in MySuper applications.

Superannuation funds have until 2017 to move accrued default amounts held by members (amounts for which no investment direction has been given[3] (ADAs)) into a complying MySuper product. However, members are not compelled to accept the product chosen by the fund and are given a minimum of 90 days' notice before the transfer so that they have the opportunity to opt-out of the transfer.[4]

1. Fees

Permitted fees for MySuper products are:

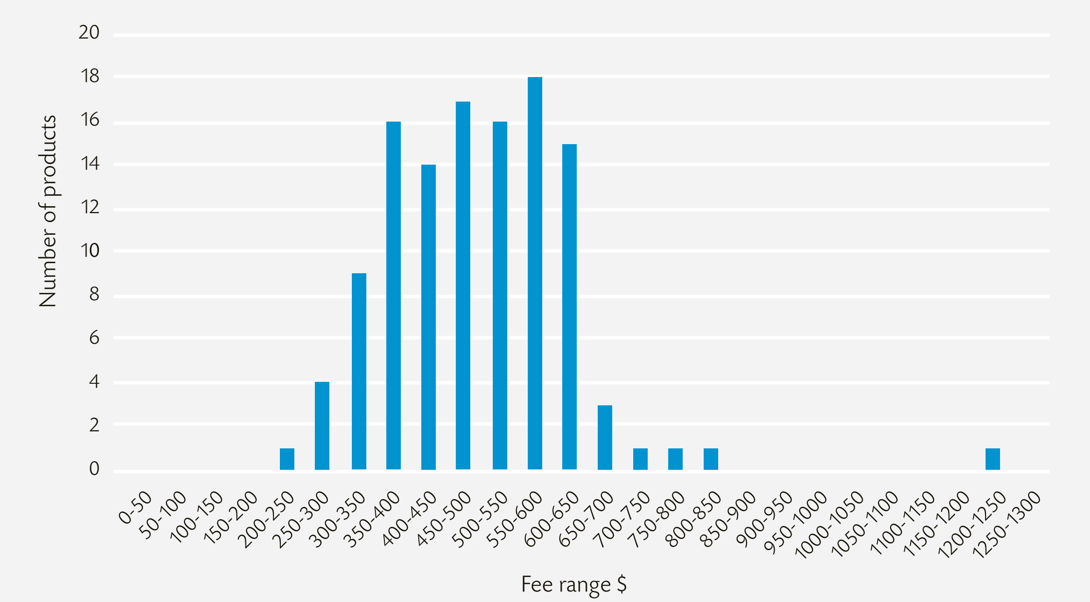
- administration fee: for the administration or operation of the fund;
- investment fee: for the investment of the assets of the fund;
- buy-sell spread: for transaction costs relating to the sale and purchase of assets of the fund;
- switching fee: for the cost of switching a member's interest within the fund;
- exit fee: for the cost of disposing of the member's interest in the fund;
- activity fee: for the cost of, for example, processing an account-splitting application pursuant to a Family Court order;
- advice fee: for the cost of personal financial product advice to a member; and
- insurance fee: for the costs relating to the provision of insurance to members.

All MySuper products included administration fees and investment fees, but there was variation across products as to whether the other permitted fees were to be charged to members.

Based on the data collected from the authorised MySuper products at the time of application, the average total administration and investment fee per annum for a member with a $50,000 account balance was $496 (within a range of $215 to $1242). The median was $495. The distribution is shown in Figure 2.

3 See section 20B of the SIS Act for a full definition.
4 There are different notification requirements for members of funds who are contributing to a product that is 're-badged' as a MySuper product – see SPS 410.

Figure 2: Total administration and investment fee per annum for a member with a $50,000 account balance



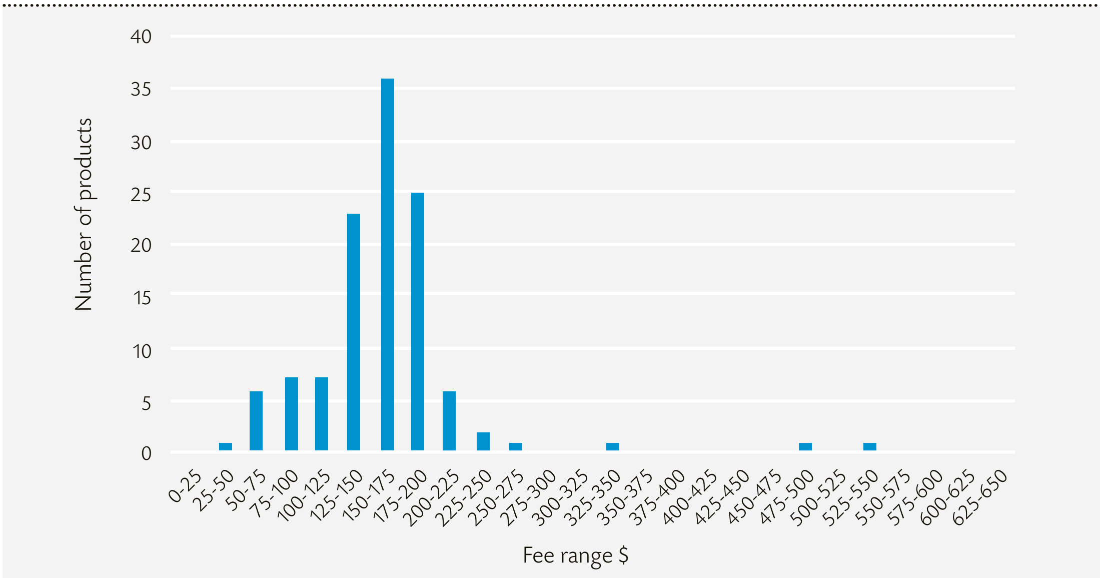
Source: Information received by APRA in MySuper applications

The average total administration and investment fee based on a member with a $10,000 account balance was $162 (within a range of $43 to $545). The median was $160. The distribution is shown in Figure 3.

a. Administration fees

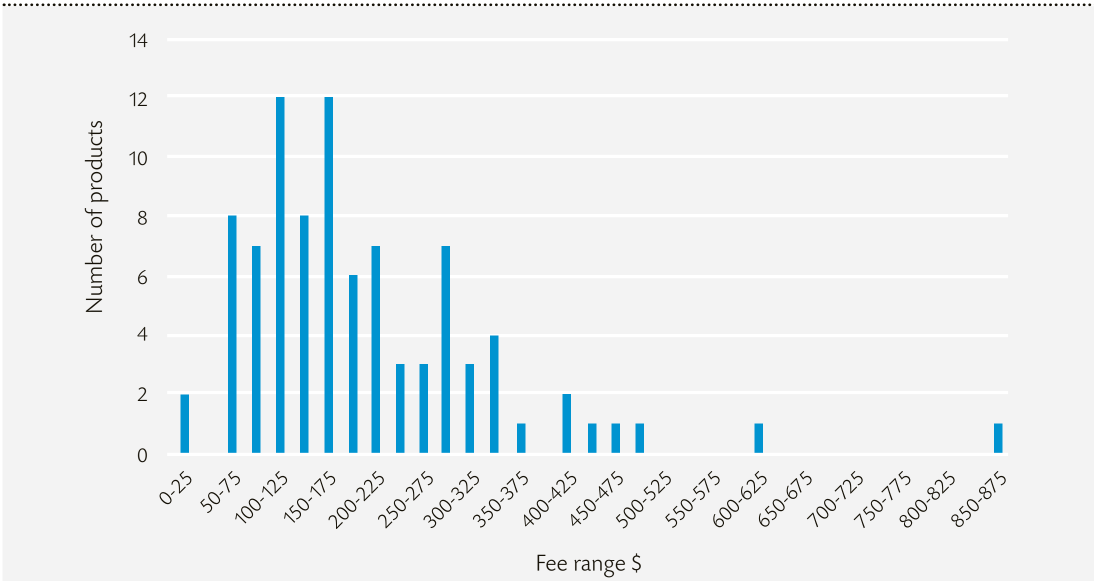
The average annual administration fee for a member with a $50,000 account balance in a MySuper product using a single diversified investment strategy was $199 (within a range of $0 to $867). The median was $165. The distribution is shown in Figure 4.

Figure 3: Total administration and investment fee per annum for a member with a $10,000 account balance.



Source: Information received by APRA in MySuper applications.

Figure 4: Administration fee per annum for a member with a $50,000 account balance – single diversified strategy.

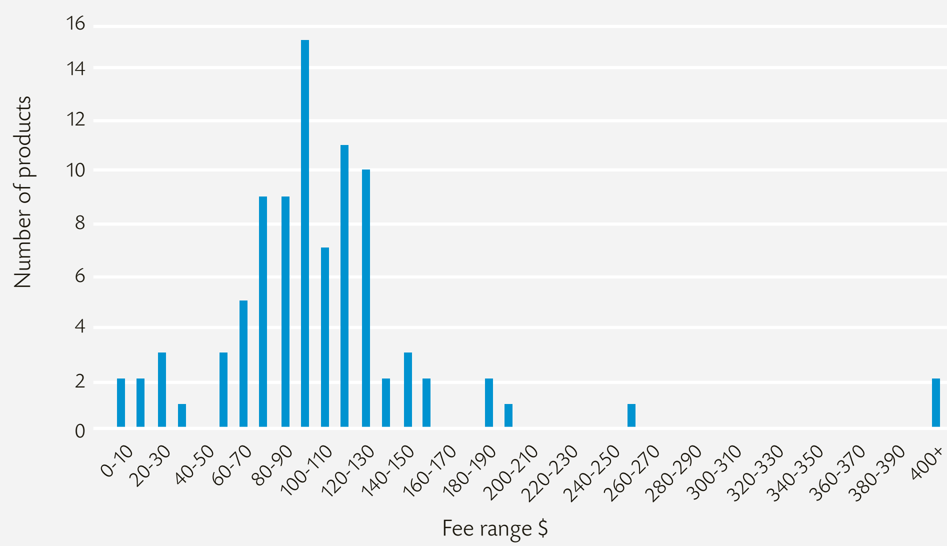


Source: Information received by APRA in MySuper applications.

The average annual administration fee for a member with a $10,000 account balance in a MySuper product using a single diversified investment strategy was $106 (within a range of $0 to $506). The median was $98. The distribution is shown in Figure 5.

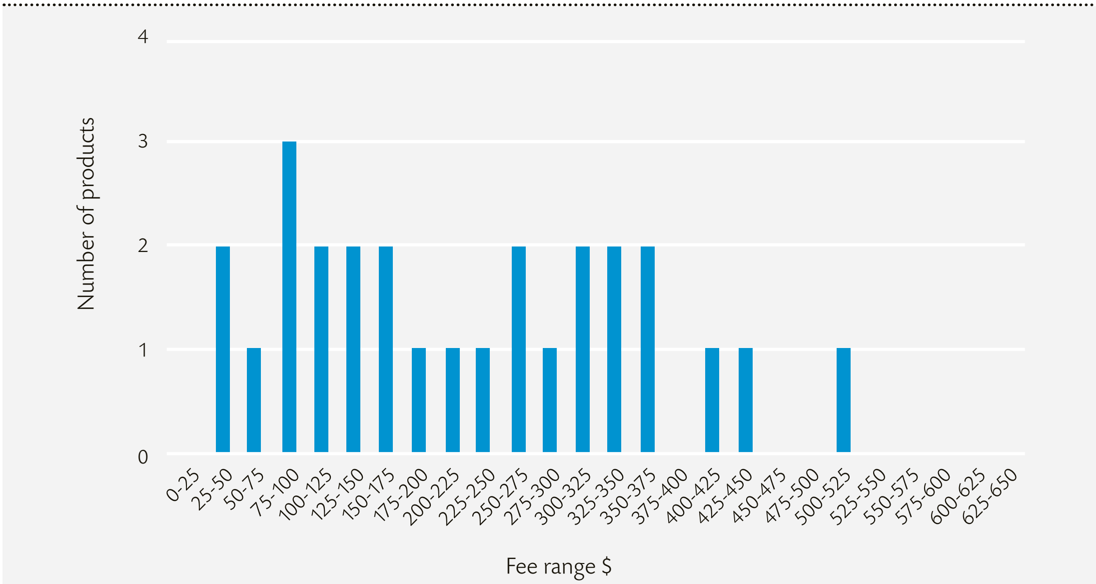
The average annual administration fee for a member with a $50,000 account balance in a MySuper product using a lifecycle investment strategy was $226 (within a range of $50 to $520). The median was $218. The distribution is shown in Figure 6.

Figure 5: Administration fee per annum for a member with a $10,000 account balance – single diversified strategy.



Source: Information received by APRA in MySuper applications.

Figure 6: Administration fee per annum for a member with a $50,000 account balance - lifecycle strategy.



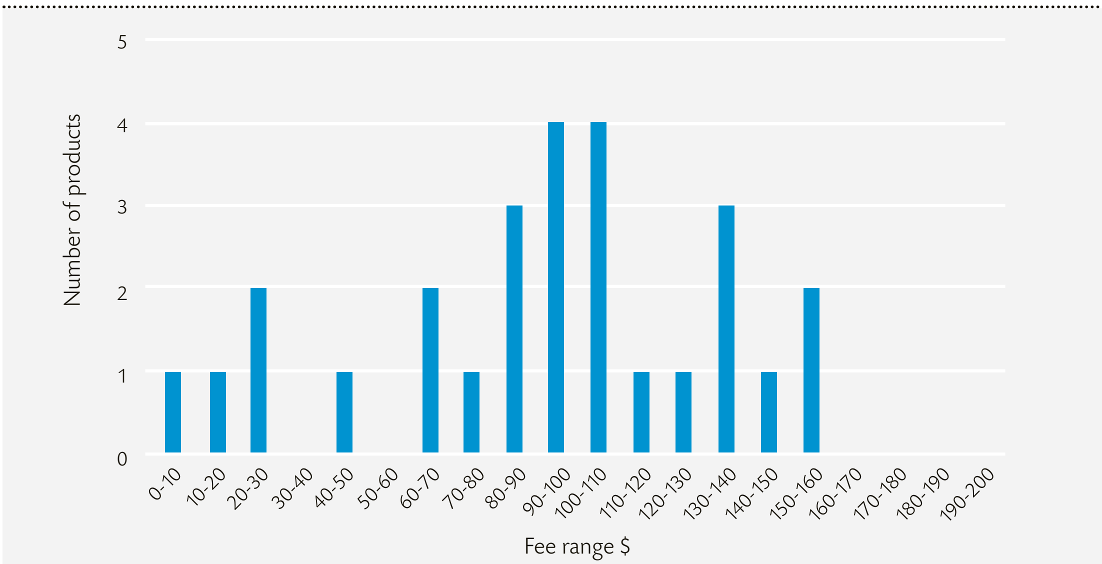
Source: Information received by APRA in MySuper applications.

The average annual administration fee for a member with a $10,000 account balance in a MySuper product using a lifecycle investment strategy was $93 (within a range of $10 to $156). The median was $98. The distribution is shown in Figure 7.

b. Investment fees

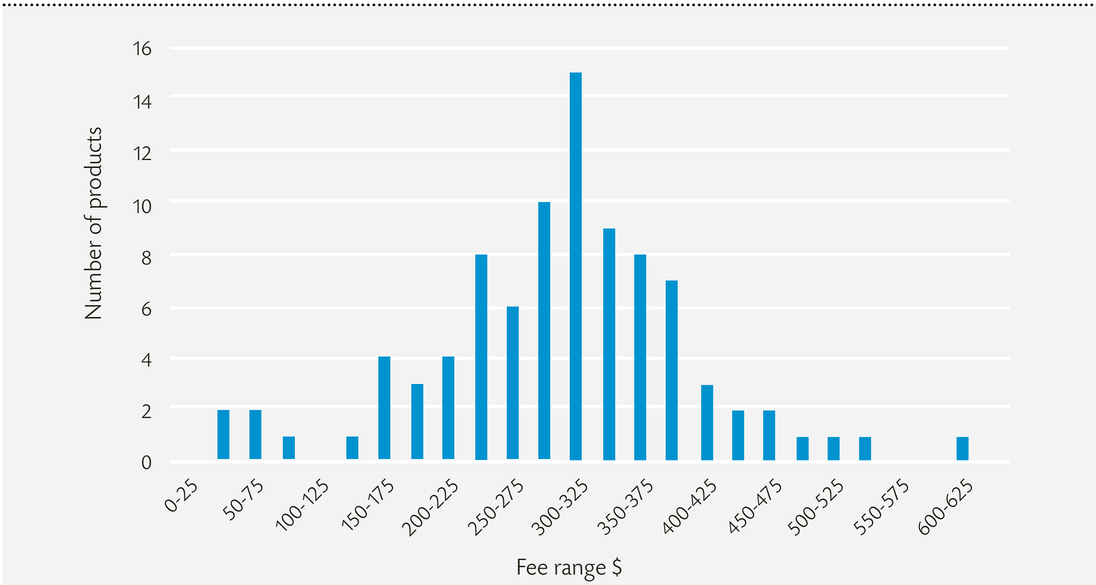
The average annual investment fee for a member with a $50,000 account balance in a MySuper product using a single diversified investment strategy was $306 (within a range of $35 to $625). The median was $305. The distribution is shown in Figure 8.

Figure 7: Administration fee per annum for a member with a $10,000 account balance - lifecycle strategy.



Source: Information received by APRA in MySuper applications.

Figure 8: Investment fee per annum for a member with a $50,000 account balance – single diversified strategy.

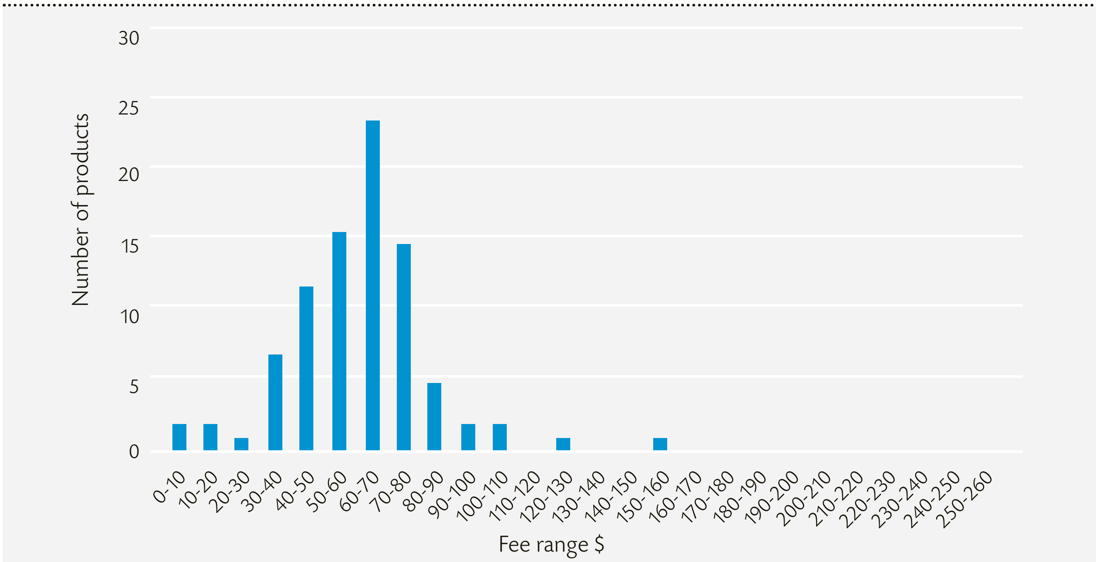


Source: Information received by APRA in MySuper applications.

The average annual investment fee for a member with a $10,000 account balance in a MySuper product using a single diversified investment strategy was $62 (within a range of $7 to $153). The median was $61. The distribution is shown in Figure 9.

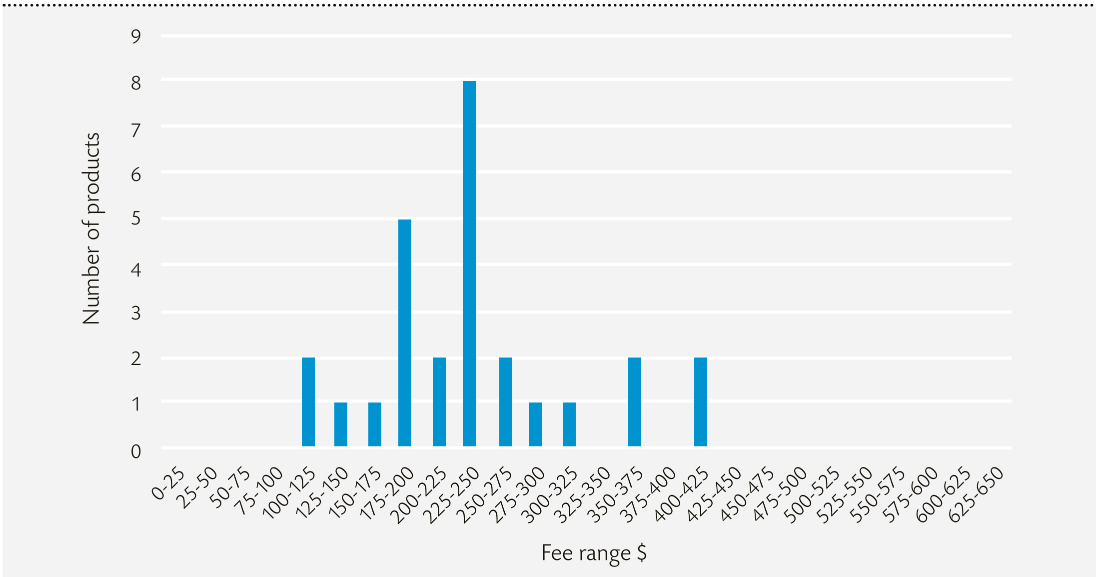
The average annual investment fee for a member with a $50,000 account balance in a MySuper product using a lifecycle investment strategy was $248 (within a range of $110 to $425). The median was $250. The distribution is shown in Figure 10.

Figure 9: Investment fee per annum for a member with a $10,000 account balance – single diversified strategy



Source: Information received by APRA in MySuper applications.

Figure 10: Investment fee per annum for a member with a $50,000 account balance – lifecycle strategy



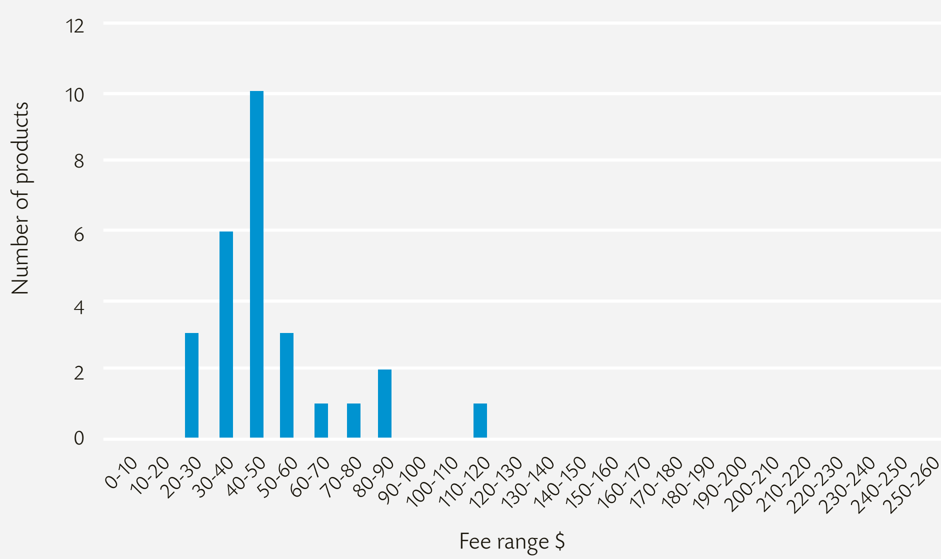
Source: Information received by APRA in MySuper applications.

The average annual investment fee for a member with a $10,000 account balance in a MySuper product using a lifecycle investment strategy was $51 (within a range of $22 to $112). The median was $50. The distribution is shown in Figure 11.

Figure 12 illustrates the average proposed MySuper administration fees and investment fees per annum for balances from $2,000 to $50,000 over all fund types.

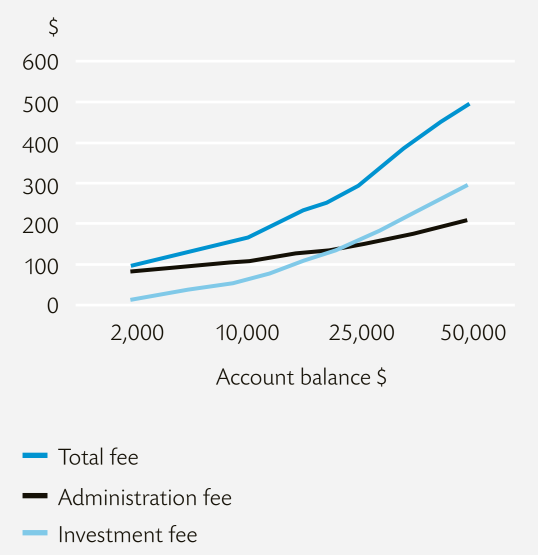
Figure 13 illustrates the average proposed MySuper administration fees and investment fees by percentage of fund balance per annum for balances from $2,000 to $50,000 over all fund types.

Figure 11: Investment fee per annum for a member with a $10,000 account balance – lifecycle strategy.



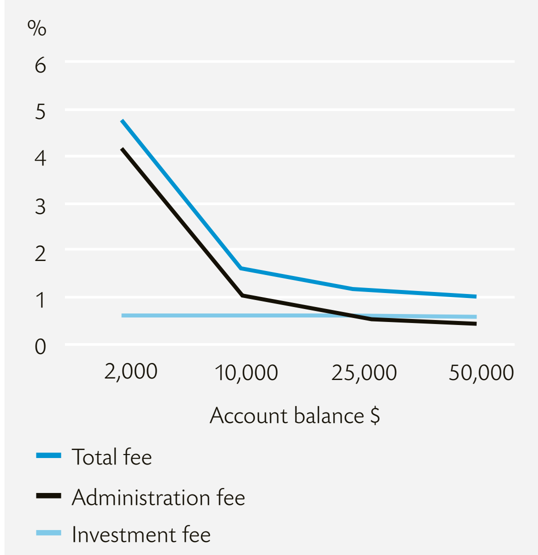
Source: Information received by APRA in MySuper applications.

Figure 12: Average MySuper administration fees and investment fees for all fund types.



Source: Information received by APRA in MySuper applications.

Figure 13: Average MySuper administration fees and investment fees by percentage of fund balance.



Source: Information received by APRA in MySuper applications.

2. Investments

MySuper products must have a single, diversified investment strategy that promotes the financial interests of members. A lifecycle investment strategy is also able to be offered, and 27 applicants proposed a lifecycle investment strategy.

Based on data provided to APRA in applications for non-lifecycle MySuper products:

- the median allocation to growth assets[5] was 71 per cent (within a range of 50 per cent to 85 per cent);
- the median 10-year rolling investment return objective was CPI plus three per cent (within a range of two per cent to 5.5 per cent); and
- the median risk objective or standard risk measure (being the number of negative return years within a 20-year period) was four years (within a range of 2.2 to six negative return years).

A lifecycle investment strategy enables RSE licensees to automatically move members into a different investment mix based on their age and other factors (such as gender, account balance, contribution rate and salary). The strategy typically involves the systematic transition of members from 'higher risk' growth assets such as equities to 'lower risk' defensive assets such as bonds as retirement approaches, by decreasing the allocation to growth assets and increasing the allocation to defensive assets. In contrast, a traditional single diversified investment option strategy generally provides the same asset class exposure across all ages and other membership factors, although the allocation between growth and defensive assets would be periodically reviewed.

5 While there were some individual variations in the definitions contained in the investment strategies that were submitted by RSE licensees as part of their applications, all growth assets constituted investments made with the objective of achieving an investment return, such as capital growth and income that outperformed the rate of inflation.

There were a number of variations of lifecycle investment strategies amongst the applicants. The approach to changing the asset allocation based on the age of the member or other factors (referred to as the 'glide path') involved:

- amending the asset allocation in which the member is invested at particular milestones (i.e., the level of exposure to particular asset segments is changed at each milestone); and/or
- allocating members to cohorts based, for example, on their age or date of birth (e.g. a cohort may be all members born between 1961 and 1970) and having progressively different asset allocations for each cohort.

3. Operational risk financial requirement (ORFR)

The ORFR is the amount of financial resources held by the RSE licensee to address operational risk events that may affect its business operations. APRA expects soundly run RSE licensees that have implemented an effective risk management framework to have an ORFR target amount that is equivalent to at least 0.25 per cent of funds under management.[6] The requirement to hold an ORFR commenced on 1 July 2013[7], and an RSE licensee may build its financial resources to meet its ORFR target amount within three years of 1 July 2013 so that the financial burden of building the ORFR is spread equitably across fund members over time.

6 Funds under management are regarded as the total of asset balances of each RSE within the RSE licensee's business operations: paragraph 9, *Prudential Practice Guide SPG 114 Operational Risk Financial Requirement.*

7 See *Prudential Standard SPS 114 Operational Risk Financial Requirement.*

Based on the MySuper products authorised by APRA:

- the average ORFR target amount was 27.5 basis points (with a range of 25 to 50 basis points).[8] The RSE licensees of 38 authorised MySuper products have indicated an ORFR target amount of greater than 25 basis points;
- the RSE licensees of 36 authorised MySuper products indicated that the ORFR target amount would be met from 1 July 2013; and
- the average tolerance limit was 84 per cent (with a range of 80 per cent to 100 per cent). A tolerance limit is required because the ORFR may be diminished through its use to address losses arising from operational risks or the performance of the investments that make up the ORFR. The tolerance limit is the point below the ORFR target amount at which the RSE licensee has decided it must take action to replenish the financial resources held to meet the ORFR target amount.

Issues encountered in implementing the MySuper reforms

1. The timetable for legislative reforms

Applicants for MySuper product authorisation initially expressed concerns about the timetable for superannuation law reform. While the MySuper authorisation process commenced on 1 January 2013, six significant legislative and regulatory amendments relating to the MySuper product were made between September 2012 and June 2013. As RSE licensees were able to offer a MySuper product from 1 July 2013, the product offering for those RSE licensees who had applied prior to 1 July 2013 was still subject to change after authorisation until the last regulations were finalised in June 2013.

8 This excluded 12 applications that proposed to use an offset for investments in a life policy or PST.

2. Enhanced trustee obligations

The areas in which most feedback was provided by APRA to RSE licensees during the MySuper application process included the enhanced trustee obligations contained in new covenants in the SIS Act and the requirements in APRA's prudential standards for governance, conflicts of interest, investment, insurance, risk management and the ORFR. Some common issues that arose, and APRA's approach to those issues, are outlined below.

a. Conflicts of interest

In relation to *Prudential Standard SPS 521 Conflicts of Interest*, the submitted policies were generally drawn at a whole-of-fund level, and APRA gave consideration to the RSE licensee's existing approach in determining likely compliance with SPS 521. APRA also assessed the extent to which the Register of Relevant Duties and Interests reflected the current operations of the RSE licensee and, where this did not appear to be adequately reflected, APRA sought changes to the Register.

APRA's supervisory experience has led to the conclusion that more work is required by RSE licensees on the identification, management and avoidance of conflicts. In general terms, the policies relating to management of conflicts often only covered minimum requirements and there was significant variation in the level of disclosure and reporting, with a wide range of thresholds used to determine the relevance of an interest or duty.

APRA's supervisory experience has led to the conclusion that more work is required by RSE licensees on the identification, management and avoidance of conflicts.

APRA has also been concerned that the solution most commonly used to resolve conflicts has been for the relevant person to abstain from decision-making. The effectiveness of board-decision making may be significantly (and adversely) affected where a director is required to frequently abstain due to conflict issues. Further comments on this issue are in the *Superannuation Industry Overview* article in this issue of *Insight.*

b. Investments

As noted above, the SIS Act requires the MySuper product to have a single, diversified investment strategy that promotes the financial interests of members. Factors that APRA considered in reviewing the proposed investment strategies included the number of proposed asset categories in the strategy, the types of asset classes and the management of the risks related to the investments covered by the strategy. APRA also considered whether there was sufficient liquidity in the fund based on expected cash flow requirements, consistent with the amended trustee covenants in the SIS Act.

Lifecycle investment options resulted in added complexity in the design of the investment strategy for the relevant MySuper products. As a lifecycle option involves different asset allocations for specified lifecycle stages, APRA expected detailed information on how the RSE licensee determined the various stages within a lifecycle strategy, the investment objectives for each stage and any specific risks that were identified and how they were to be managed as part of the application.

APRA assessed the adequacy of the information that was provided, including the reasonableness of the proposed stages given the characteristics of the likely membership of the product, and whether the proposed investment mix at each stage had due regard to the need for diversification and liquidity.

c. Insurance in MySuper

Section 68AA of the SIS Act requires RSE licensees to provide insurance benefits for death and permanent incapacity to members of a MySuper product on an opt-out basis. However, the RSE licensee may determine reasonable conditions to which the provision of permanent incapacity benefits or death benefits is subject.

Section 68AA of the SIS Act requires RSE licensees to provide insurance benefits for death and permanent incapacity to members of a MySuper product on an opt-out basis.

The reasonableness of the proposed conditions for exclusion from opt-out insurance coverage was the subject of considerable discussion between RSE licensees and APRA during the MySuper authorisation process. APRA expected the proposed conditions to be based on the RSE licensee's assessment of the availability and cost of third-party insurance cover, such as for age or pre-existing medical conditions. APRA recognised that there was scope for varying insurance benefits, different insurance fees, different default levels of cover and different automatic acceptance limits due to particular factors at a workplace level. However, APRA's view was that any proposed wholesale exclusion of broad categories of members required substantial justification. For example, it was not necessarily reasonable to exclude all members who did not have a standard employer-sponsor from the provision of death and permanent incapacity insurance on an opt-out basis unless the RSE licensee demonstrated that third-party insurance was not available, or was not available at a reasonable cost, for that segment of members.

Another issue reviewed by APRA was the approach proposed by RSE licensees to the change in the definition of permanent incapacity in the SIS Act from 1 July 2013. This change requires RSE licensees to align their total and permanent disability (TPD) insurance with the condition of release for permanent incapacity in the SIS Act from 1 July 2014. As the new condition of release differed from many of the traditional insurance offerings by RSEs for TPD insurance, many RSE licensees sought clarity on whether any conditions in the existing TPD arrangements could continue after 1 July 2014.

As noted in the superannuation industry overview article in this issue of *Insight*, issues related to insurance will continue to be a matter for supervisory review by APRA, and are the subject of one of APRA's thematic reviews of implementation of the new prudential standards.

d. Operational Risk Financial Requirement (ORFR)

The requirement to hold resources to cover operational risks under the SIS Act came into effect on 1 July 2013, and there were many discussions between APRA and RSE licensees on the adequacy of proposed ORFR target amounts and tolerance limits, the alignment of the ORFR with the RSE licensee's risk management framework, and the appropriate use and replenishment of the ORFR. The application of offsets in the calculation of the ORFR for investments in life policies and pooled superannuation trusts were clarified by APRA in *Prudential Practice Guide SPG 114 Operational Risk Financial Requirement.*

A number of approaches were used by RSE licensees to arrive at the ORFR target amount and tolerance limits. APRA considers that the development of more sophisticated entity-specific models for the determination of the ORFR target amount should be a longer-term objective for the industry, and APRA expects to refine its guidance on ORFR target levels and approaches over time.

3. Fees

Some types of fees for MySuper products are required to be set on a cost-recovery basis. As part of the application process, APRA expected evidence to be provided of the steps that RSE licensees were taking to ensure that the relevant fees were being charged on a cost-recovery basis. This may have included, for example, how the previous year's cost (or the average cost over a specified period) had been identified for the particular activity, and how the RSE licensee calculated the proposed cost recovery fee. APRA did not prescribe a particular methodology; rather, it assessed the reasonableness of the RSE licensee's approach and, in some cases, requested further information. In some cases it was apparent that charging practices were not sufficiently transparent.

Future supervision issues

A key feature of MySuper is the new set of duties for RSE licensees, including a specific duty to promote the financial interests of its MySuper members and the net returns to those members, and to determine whether the financial interests of its MySuper members are disadvantaged compared to members of other MySuper products due to insufficient scale in terms of members or assets. APRA will be reviewing the effectiveness and implementation of the approaches used by RSE licensees to meet these obligations.

A key feature of MySuper is the new set of duties for RSE licensees, including a specific duty to promote the financial interests of its MySuper members and the net returns to those members...

Other areas on which APRA will be focusing when reviewing implementation of MySuper products include:

- the performance of the MySuper product against its investment return target;
- the approach to measurement of the standard risk measure and the performance of the MySuper product against this measure;
- fee levels and structures, to ensure that the intent of MySuper (in relation to the scope of fees and cost-recovery requirements) is met;
- the identification of ADAs in the MySuper transition plan and the progress of transition of ADAs to a MySuper product in accordance with the plan; and
- ongoing compliance with the insurance requirements for MySuper products, including the extent of, and reasons for, exclusions from opt-out insurance in MySuper.

Summary

APRA's experience of the MySuper authorisation process has been positive, with RSE licensees responding well to APRA's request to engage in the process early. Many RSE licensees provided draft applications and draft policies to APRA for review, which helped to ensure that final applications appropriately addressed all relevant matters. APRA supervisors worked closely with RSE licensees to ensure that applications were complete and included sufficient documentation for APRA to make its decision. There were also benefits to applicants' broader operations from APRA's feedback on the implementation of the new superannuation prudential standards as part of the MySuper authorisation process.

The MySuper authorisation process went reasonably smoothly, and much of that was due to the generally collaborative approach between RSE licensees and APRA during a time of ongoing legislative change and the implementation of superannuation prudential standards.

APRA now expects to see RSE licensees authorised to offer MySuper products delivering on the commitments they made as part of their applications, and it will continue to work with RSE licensees to ensure that this occurs.

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Operational due diligence of investment managers

This article provides an overview of APRA's expectations for due diligence to be performed on investment managers by APRA-regulated superannuation entities, with a special focus on the need for, and importance of, operational due diligence.

Introduction

Registrable Superannuation Entity (RSE) licensees are responsible for formulating and implementing an investment strategy for each option that they offer to members. A fundamental component of effective implementation of these strategies is deciding who will implement components of each investment strategy. Where external investment managers are engaged for this purpose, adequate due diligence is critical. This is reinforced by the requirements of *Prudential Standard SPS 530 Investment Governance* (SPS 530) and *Prudential Standard SPS 231 Outsourcing* (SPS 231). Furthermore, *Prudential Standard SPS 220 Risk Management* (SPS 220) emphasises the obligation to have an appropriate risk management framework addressing all material risks.

The need for investment due diligence, examining the investment philosophy and process, portfolio composition and performance of the investment manager and the relevant products is well recognised. Also of great importance, but frequently receiving less attention, is the need for operational due diligence on the investment manager. This is essential for the RSE licensee to understand the ability of the investment manager to adequately deliver on its representations, and hence to be able to fulfil its intended role in meeting the RSE licensee's investment strategy and achieving its investment objectives.

Due diligence

A fundamental decision, or series of decisions, for RSE licensees when implementing their investment strategy is who will implement the strategy, or components of it, to enable the RSE licensee to meet its obligations to beneficiaries. Investment managers are key service providers that are often relied on by RSE licensees to implement their investment strategies.

Due diligence is the process of analysing the philosophy, people and processes of the investment manager to ensure that it is able to perform the functions for which it has been appointed. It is natural to focus on investment aspects in the due diligence process. However, due diligence on operational aspects of the investment process is also required to assess whether the investment manager has the operational capabilities required. The due diligence undertaken by RSE licensees therefore needs to assess all aspects of the investment manager's operations.

Due diligence is the process of analysing the philosophy, people and processes of the investment manager to ensure that it is able to perform the functions for which it has been appointed.

The need for operational due diligence

The need for operational due diligence is best demonstrated by the oft-quoted research[1] into hedge fund failures, which states that more than 50 per cent of such failures are due to breakdowns in the operational environment. While this research was specific to hedge funds, it highlights the importance of understanding the operational environment within an investment manager.

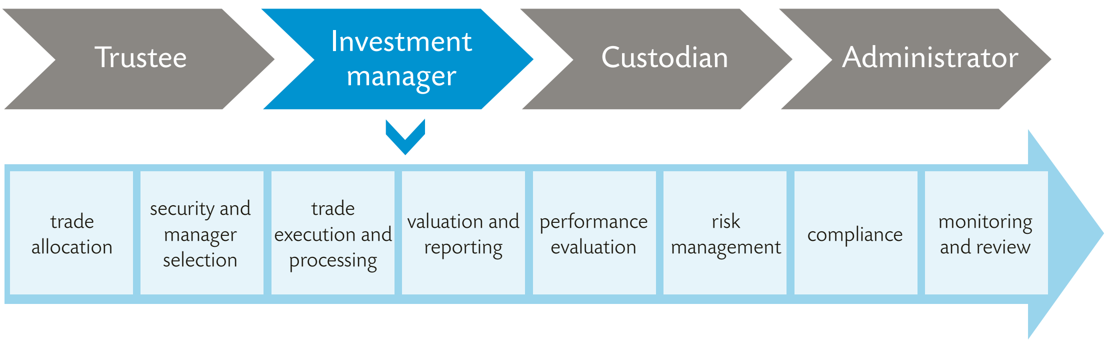
While 'failure' of a fund or investment manager is an extreme outcome, if operational management is deficient it could detract from returns, or lead to the adoption of a different risk profile to that intended, possibly working against the benefits of the investment strategy that is being sought. Simply, if the control environment within the investment manager is deficient, there are many opportunities for things to go wrong.

It is also worth noting that, unlike investment risk, operational risk does not provide a risk premium and hence bearing operational risk is unrewarded. Nevertheless, the level of operational due diligence undertaken by RSE licensees is often not as intensive or extensive as that which is applied to investment due diligence.

In effect, when engaging an investment manager, like any other external provider, the RSE licensee has engaged an external party to form part of its value or process chain. Alignment between different sections of the chain is critical to achieving desired objectives and risk, of all types, and needs to be effectively managed through the chain.

1 Feffer & Kundro (2003), '*Understanding and Managing Operational Risk in Hedge Funds*' Working Paper Capital Markets Company.

Figure 1: Value chain



There are many processes that need to work effectively for the investment manager to deliver to its agreed mandate. At one extreme is to actually stay in business, and to have an appropriate business continuity plan that enables it to withstand a serious event. However, there are numerous other processes and functions that need to be considered. Assessment of the ultimate suitability of an investment manager by an RSE licensee requires an understanding of the processes within the investment manager, the dependencies, both internally and with the investment manager's own service providers, and the risk control framework and culture that exists within the manager's operations.

If all of these do not operate effectively:

- the RSE licensee will be unable to realise the full benefit of the manager's investment expertise (for example, if the manager lacks the operational capabilities to execute its declared strategy);
- the manager may not be able to adequately fulfil its role as part of the RSE licensee's value chain (for example, if reporting were so deficient that the trustee was unable to rely on information provided, potentially impacting on other investment decisions); and/or
- there may be a fundamental breakdown compromising an investment (for example, control deficiencies may allow an internal fraud to occur).

Operational risk in investment management

Operational risk is typically defined as a failure of people, processes and systems. There are numerous potential opportunities for an operational breakdown within an investment manager, as there is in any business.

The range of operational events, and their impact, varies widely and will also be impacted by the exact nature of the arrangements with the manager, including the asset class and style of investment. Common examples (some of which are elaborated on later in this article) include:

- inadequate trade execution and settlement;
- inadequate trade allocation processes;
- incorrect trading due to mistakes or to rogue trading;
- valuation errors;
- inability to process transactions;

- inability to provide reports or necessary information in a timely and accurate manner;
- failure to comply with relevant laws and regulations;
- problems managing or appointing service providers; and/or
- business disruption events.

The ability to manage and monitor investment risks is itself impacted by the ability to manage investment-related functions. For example, risk measurement will often be dependent on models or specialised systems, and will be impacted if these processes and systems are not implemented correctly.

Performing operational due diligence also provides insights into the risk culture and approach to risk management of the investment manager. This will include its ability to effectively measure and manage risk and to enact its stated investment strategy and approach. A key indicator of the manager's risk culture is the seriousness with which risk management (particularly beyond pure investment risk) is treated, and how issues raised by risk management or similar units are addressed.

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Operational functions

As noted above, there are a range of operational functions that need to be considered and evaluated as part of an RSE licensee's due diligence on an investment manager. What is also critical is the interaction between these various functions, as activities do not occur in isolation – problems in one area will impact on other areas. For example, valuation errors will lead to incorrect performance measurement, rendering it difficult for the manager (and hence RSE licensee) to understand which decisions are improving or detracting from returns.

Some of the operational functions, and the related risks, are expanded on below.

Settlement and confirmations functions

All trades undertaken by an investment manager need to be recorded correctly and carried out as specified. There also needs to be appropriate segregation of duties between the dealing, measurement and settlement functions. There should be independent confirmation of transactions and reconciliation of balances. The absence of such arrangements could lead to incorrect reporting or, more significantly, incorrect trading (whether by mistake or by design).

Furthermore, if settlement and confirmation functions do not operate efficiently and effectively, there is likely to be significant value lost due to:

- failed trades leading to both rework and an inability to get the best price; and/or
- recording errors leading to further incorrect trades, as portfolio managers are unaware of their true exposure.

Performance measurement and risk monitoring

Performance measurement is critical to understanding the drivers of risk and returns, which investment decisions have added value and the assessment of whether the specific portfolio is operating within its intended risk profile. Related to this is the need to monitor the various limits that are applied to the portfolio to ensure that investment risk is managed as intended.

It is a specific requirement of SPS 530 that there is effective separation between those making investment decisions and those measuring the impact of those decisions. This requirement applies to RSE licensees; however, it is also important that performance measurement within the investment manager is operationally independent from those making investment decisions. This will support the RSE licensee to meet obligations through reliance on this separation functioning effectively within the manager.

Performance measurement is a key part of the reporting provided by the investment manager to the RSE licensee; hence, deficiencies here will impact on the RSE licensee's assessment of overall investment measurement and monitoring.

Performance measurement and risk monitoring deficiencies are likely to lead to:

- inadequate monitoring of performance within the investment manager's business;
- greater difficulty in providing meaningful attribution explaining the sources of return, requiring increased monitoring effort by the RSE licensee;
- less likelihood of the RSE licensee detecting style drift within the manager;
- performance that is inconsistent with the intended investment style or mandate not being detected and hence not questioned by the RSE licensee; and/or
- actual risk exposures not being properly understood by the manager or RSE licensee.

Segregation of duties

SPS 530 mandates that those responsible for assessing the performance of investment decisions must be operationally independent of those who make the investment decisions. This is not, however, a principle unique to superannuation. In many contexts the principle applied is that those who handle assets or funds or make relevant decisions should not also be the ones with responsibility for ultimately recording and valuing those assets or funds. For example, this principle has been applied in banking for many years and its failure is frequently cited as a contributor to various rogue trading incidents.

Basel Committee on Banking Supervision x(BCBS) requirements make reference to arrangements of this type. For example, in relation to the management of interest rate risk, the BCBS states 'Banks should have risk measurement, monitoring and control functions...that are sufficiently independent from position taking functions of the bank'. Similarly, work by the Senior Supervisors Group with many of the world's largest financial institutions indicates wide agreement with the view that 'areas responsible for carrying out key valuation processes must be independent'. Without this type of separation, performance reporting is less reliable, errors are more likely and harder to detect, and deliberate breaches can remain hidden.

Confirmations

Consistent with the theme of segregation of duties, as part of recording positions confirmations need to be obtained from the counterparty, independently of the area that undertook the transaction. This independently verifies the existence of the transaction, as well as the value of the consideration that will be received.

Maintaining investment style

When appointing investment managers, a critical consideration is the investment strategy and approach that is adopted by the manager. This has implications for whether or not the investment manager fulfils its intended role as part of implementing the RSE licensee's investment strategy, as well as whether the risks taken are within the risk appetite of the RSE.

The performance measurement process should include an assessment of investment returns against relevant benchmarks or expectations, which are set based on the desired investment strategy and approach. When managers 'drift' from their declared strategy and approach, or declared style (hence the term 'style drift'), the desired role of the investment manager as part of the RSE licensee's strategy is unlikely to be achieved.

Performance measurement should help to detect style drift. Performance that is not consistent with expectations is an indication that further investigation is needed.

Valuation/reporting

Valuation of investments within the portfolio is critical. Without accurate and timely valuation it is not possible to accurately measure performance, rendering performance measurement less meaningful. Similarly, many other risk measures and controls rely on the value of positions being recorded accurately. If there is not an accurate valuation of a portfolio or its components, it is also hard to manage the portfolio going forward due to the lack of clarity on the composition of the portfolio. Furthermore, if valuation is not done in a timely and accurate manner it will not be possible to provide the necessary reporting to the RSE licensee. Valuation problems may also lead to other inefficiencies, for example time spent reconciling unexplained differences.

A critical component of the valuation process is the independence and capability of staff assigned to perform valuations. Frequently, external expertise will be needed and the manager will need to have a process for assessing and appointing valuers. A robust internal governance process is also needed to address complex valuation issues that may arise due to the nature of the assets or instruments used, and to effectively manage the valuation process.

Trade allocation processes

Trade allocation processes are particularly relevant where the investment manager runs multiple mandates or funds, and especially if it operates in markets that are relatively thinly traded or with limited capacity.

There needs to be a process (which is auditable within the manager) for allocating trades to ensure that opportunities are fairly shared between various clients, with no client receiving preferential treatment by receiving a disproportionate share of the best opportunities or the best prices. This is particularly important where the investment manager is also managing its own products that are offered directly to others (and hence it has an incentive to obtain better performance for those products).

Related-party issues

If the investment manager has dealings with related parties, the manager needs to document how possible or perceived conflicts are addressed. Specifically, the manager needs to be able to demonstrate that transactions are at arm's length, and are in the investors' interests. RSE licensees should ensure that the investment manager's conflict management processes address:

- how potential and actual conflicts are identified;
- once identified, the process for managing such potential conflicts; and
- the process for reporting to the RSE licensee on any potential and actual conflicts and the effectiveness of their management by the investment manager.

The RSE licensee needs to understand the corporate structure and ownership of the manager. An awareness of the activities of the principals is also beneficial. Enquiries should be made as to the existence of relevant registers of interests, and an understanding obtained of the process for managing those registers, and responsibility for addressing any conflict issues that are identified. The attitude of key staff and directors toward such conflicts is also critical.

Any assertions that there is 'no such thing as an unmanageable conflict' should be treated sceptically by the RSE licensee.

Depending on the nature of potential or actual conflicts, methods of management by the investment manager may include benchmarking to market prices, processes for splitting the relevant decision-making body or abstention of individuals. It is also important to assess the relevant thresholds for such approaches. For example, there would be a level of abstention that would render a decision-making body ineffective or an individual unable to meaningfully contribute. There should also be articulation of which conflicts (and to what extent) could be tolerated and managed and which would be considered unmanageable. Any assertions that there is 'no such thing as an unmanageable conflict' should be treated sceptically by the RSE licensee.

Reconciliations

Reconciliations of items, including accounts, balances, trades and assets holdings, between managers, custodians and other service providers are a critical control, and there needs to be clarity that these are being performed and followed up on. Responsibility for reconciliations needs to be assigned and monitoring needs to ensure that reconciliations are being done and that there is an awareness of the age of items on reconciliations. Reconciliations not being up-to-date or followed up are a sign of serious control breakdowns.

Ineffective interaction by the investment manager with its service providers could lead to problems for the RSE licensee.

IT systems

The operational aspects of investment management are generally heavily IT-dependent – from the process of recording and executing trades and allocating trades between clients and portfolios, to the aggregation of position and valuation data and the calculation of performance and risk exposures. It is simply not feasible to operate this type of business without effective IT systems that are fit for the size and complexity of operations. IT failures would have a severe impact on the investment manager's operations.

The ability to manage system upgrades or transitions is also important, as is the sufficiency of IT resources.

Business continuity

Investment managers need to have business continuity plans (BCPs) in place. Significantly, RSE licensees need to understand those plans and the impact they may have on their own operations. The degree to which the RSE licensee relies on investment managers to continue aspects of its operations needs to be reflected in its own BCP and needs to be congruent with the investment managers' BCPs.

Service providers

The investment manager needs to have proper processes for the appointment of service providers (essentially its own due diligence processes). It is also critical for the RSE licensee to understand the nature of the investment manager's relationships with service providers, how reliant it is on those service providers and, to the extent possible, the nature of its agreements and key contract terms with service providers.

Ineffective interaction by the investment manager with its service providers could lead to problems for the RSE licensee. Notable examples would be ineffective interaction with the custodian (for example when starting to use new instruments) or with an outsourced unit pricing provider (when developing a new product). The absence of such interaction could, respectively, lead to investments in instruments that are difficult to value and monitor, or the development of products for which it is difficult to equitably establish unit prices.

Compliance

Investment managers need to have stringent policies and processes to ensure that they comply with relevant laws. It is desirable that the investment manager observe the same high standards of ethics and approach to these issues as the RSE licensee. The interactions in relation to compliance-related issues provide a key insight into the attitudes and culture of the organisation. Does the organisation aim to meet only the letter of the law and is there an attitude that finding ways to meet the technical requirements while clearly breaching the intent is acceptable? This type of attitude or culture should be of concern to any RSE licensee.

A related issue is the need for RSE licensees to ensure that they will be able to get from investment managers the information that they need to comply with reporting and disclosure obligations to APRA and other regulators.

Risk management

Effective risk management by investment managers is important, and proactive management of business risks and identifiable ownership of issues should be expected by RSE licensees.

Many other areas of an investment manager's operations are reliant on the internal risk management functioning effectively. Specifically, if operational risks are not managed effectively, other risks will also likely be ineffectively managed. For example, if the risks related to the IT systems, or model risk, are not well managed, it will be difficult for the organisation to consistently and reliably measure its exposures.

Boundaries

Investment managers need to define the boundaries between different areas and understand the implications of the demarcations that exist. This would include activities that could be considered an investment activity or an operational activity. One example would be currency hedging. If this is considered an investment activity, this will likely lead to a greater focus on best execution and better prices (as this impacts on how portfolio managers and dealers are evaluated) than if this is seen as an operational or administrative task, to be completed by a certain time in the day.

Evidence

The prudential standards create a positive and enforceable obligation on the RSE licensee to demonstrate compliance with prudential requirements and the expected processes and risk management. Therefore, RSE licensees need to be able to demonstrate:

- due diligence policies and processes, including the conduct of operational due diligence;
- performance expectations with respect to the operational processes of investment managers they engage; and
- evidence for all appointments showing completion of the required due diligence, and how the final assessment was made.

Frequently, the due diligence process would include a combination of preliminary analysis, questionnaires with off-site assessment and, in the final stage, on-site meetings and inspections.

Conclusion

Investment managers play a vital role in the execution of components of the investment strategy, and consequently it is important that RSE licensees perform thorough due diligence to ensure that managers are able to fulfil their intended role. This due diligence needs to cover both operational and investment aspects, and should include critical areas of the investment manager's activities that are integral to the provision of services to RSE licensees. This would include an understanding of the functioning of the investment operations, accounting, compliance, risk management, IT systems and processes and the management of service providers.

As part of its ongoing supervision and risk assessment, APRA will assess RSE licensees' compliance with the prudential standards and its management of both investment and operational risk. This will include, where warranted, an assessment of the processes around operational due diligence of investment managers.

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