Effectively assessing member outcomes

SUBMISSION

March 2018

Industry Super Australia

ABOUT INDUSTRY SUPER AUSTRALIA

Industry Super Australia is a research and advocacy body for Industry SuperFunds. ISA manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of over five million industry super members. Please direct questions and comments to:

Kathy Roden
Senior Legal Counsel
03 9657 4333
kroden@industrysuper.com

ISA Pty Ltd ABN 72 158 563 270 Corporate Authorised Representative No. 426006 of Industry Fund Services Ltd ABN 54 007 016 195 AFSL 232514

STRENGTHENING MEMBER OUTCOMES

Contents

INTRODUCTION

Industry Super Australia (ISA) appreciates the opportunity to provide comment on the Australian Prudential Regulation Authority (APRA) Strengthening member outcomes consultation package.

The package covers a range of proposed changes, including:

- a new Prudential Standard SPS 225 Outcomes Assessment
- a new Prudential Practice Guide SPG 225 Outcomes Assessment
- amendments to existing Prudential Standard SPS 220 Risk Management
- replacing and introducing a new Prudential Practice Guide 221

We agree with APRA's objectives in these proposals. However, we have grave concerns that they will not achieve their objective.

The proposed measures intended to improve member outcomes, in particular are too nebulous and need significant change to effectively deliver on their purpose.

1. Member outcomes

The proposed Prudential Standard SPS 225 will require an RSE licensee to annually assess all member outcomes. At a minimum it requires the RSE licensee to detail how it has designed its assessment including how it has decided to segment its business, the metrics it has used to measure beneficiaries outcomes and its conclusions as to whether the outcomes it seeks to provide are being met. In doing so the RSE licensee must have regard to the fund's investment strategy, scale, significant fund expenditure, insurance offerings and product features.

The proposed prudential standards and guidance in respect of assessing member outcomes rest upon two underlying assumptions. First, that trustees are continuing to offer products and services that are relatively poor value for members simply because the trustee is unaware that these products and services are poor. Second, that by requiring trustees to assess the outcomes delivered to members, trustees will "do the right thing" by their members. However, these assumptions seem most unlikely to be true. Trustees of funds that offer products which result in relatively low net benefits to members generally already know this.

1.1 The proposed standards and guidance are most unlikely to be effective because they are too nebulous and provide excessive discretion to trustees

To effectively assess a superannuation product requires identifying the criteria on which it will be judged, the method for measuring the factors, and the method for evaluating the instrument based on those factors (including their weight and specifying benchmarks).

The proposed member outcomes assessment framework does not specify key indicators,[1] how to measure and apply them, nor identify benchmarks.

The proposed standards encourage (i) member segmentation, (ii) product or 'business' segmentation and (iii) a broad approach to assessing outcomes, providing an RSE licensee with three ways by which to select the basis and benchmarks on which it compares its product.

The assessment framework could vary greatly from fund-to-fund, and product-to-product. This level of discretion will undermine the robustness of comparisons, enabling trustees to select their benchmarks and bases of comparison to justify products and practices that are objectively substandard.

This risk is particularly acute in respect of Choice products with draft SPG 225 stating that APRA's preliminary view 'is that key outcome metrics would include net returns relative to return targets for each fund's MySuper product, operating cost ratios and insurance products' and that it expects an RSE licensee to consider similar metrics when considering outcomes across all products.' This language could imply that APRA may intend to take a less rigorous approach to assessment of member outcomes for choice products.

The proposal to encourage assessment against risk-return targets rather than benchmarks will undermine the endeavour. Risk-return targets can be low and do not determine member outcomes. Assessment against them would not require external comparison.

This level of discretion will also undermine the ability of APRA to supervise the framework, because an APRA inspection of multiple large superannuation organisations could involve reviewing countless different methodologies for assessing products, including custom weighting of factors and bespoke adjustments to data. APRA invites this burden when it welcomes "sophisticated modelling".

Different funds will invariably use different methodologies to assess their funds and products, along different member segments. In some cases, these different methodologies could be justified. But in most cases, the risk is that trustees will select methodologies that cast their current and planned approaches in a positive light.

As part of its annual review of its business plan an RSE licensee is required to consider the findings of its most recent outcomes assessment, in particular any changes to its business operations that would improve outcomes provided to beneficiaries. However, an RSE can avoid doing so if a cost benefit analysis of the change is not positive.

No detail is provided on how such an analysis should be undertaken, nor over what time horizon.

Deploying a standardised assessment framework would deliver substantial benefits in terms of rigour, and the efficient use of APRA supervisory resources, with little real downside.

1.1.1 APRA should prioritise financial outcomes for members in the form of net benefit to members as evidenced by fund-level and option-level net returns

The assessment process appears to subordinate financial outcomes for members to other, less measureable factors.

Whilst "outcomes" for members other than financial factors can be considered, APRA should not accept that long term member financial results can be subordinated to these factors. Instead, the RSE licensee should be required to demonstrate with objective evidence that non-financial factors contribute to positive financial outcomes for its members.

---

[1] Instead a lengthy and non-exhaustive list of possible factors is provided in Prudential Practice Guide 225 at page 9.

Some providers may argue that they are not seeking to have relatively high fund-level or option-level returns, but instead are positioning their fund and products as “luxury” or “platinum service” offerings.

For the reasons that follow this approach should be rejected.

1.1.1.1 APRA’s historical interpretation of the sole purpose test and fiduciary duty emphasised long term net returns, including at the fund level

In 2008, APRA stated that “The Sole Purpose Test and the trustee’s Section 52 duties under SIS [the Superannuation Industry (Supervision) Act] strongly suggest that a trustee should operate a superannuation fund in a manner which is aimed at delivering good long term returns to members, with return aspirations constrained by the need to manage investment and purchasing power risk over the longer term. In this context, examining realized fund returns over time allows an observer to draw an inference about a trustee’s ability to construct and execute a strategy which is in the members’ best interest. Accordingly, APRA considers longer term fund returns a highly relevant though not definitive indicator of superannuation trustee performance in designing and delivering an investment strategy which is in the members’ best interest.”[2]

1.1.1.2 A Trustee’s common law fiduciary duty emphasises acting in the members’ best *financial* interests

A number of cases have considered the substance of a trustee’s duty to act in the “best interests of the beneficiaries”, and specifically whether acting in the best interests of members distils into acting in their best *financial* interest. APRA’s notion of member outcomes should be faithful to this law, and prioritise financial net benefits, evidenced by net returns, above other possible “benefits”, and reflect that prioritisation in its outcomes assessment framework.

The English case Cowan v Scargill [1985] Ch 270 is the seminal authority, and clearly elevated financial interests above others in the pension fund context: “The starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries. This duty of the trustees towards their beneficiaries is paramount. They must, of course, obey the law; but subject to that, they must put the interests of their beneficiaries first. *When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests*.” (emphasis added.)[3] “In particular, the trustees of a pension fund are subject to an overriding duty to do the best they can for the beneficiaries….”[4]

It is worth noting that Cowan v. Scargill’s admonition to “hold the scales impartially” among members is in tension with strategies based on member segmentation unless the trustee carefully considers the equity of those strategies.

The case of Invensys Australian Superannuation Fund Pty Ltd v Austrac investments Limited and Others [2006] VSC 112 concerned how the distribution of the surplus of a defined benefit fund should be made. In the course of his judgement, Justice Byrne expressed the view that the SIS section 52(2) covenants (which had been included in the fund’s Trust Deed) were a codification of two obligations imposed by the common law upon trustees of superannuation funds, firstly the duty of loyalty and that the second obligation was ” …. to pursue with appropriate diligence and prudence the interests of the beneficiaries.

---

[2] Australian Prudential Regulation Authority, A Response to Review of APRA’s Investment Performance Statistics of the Australian Superannuation Industry, September 2008 at p.10

[3] Cowan V Scargill[1985] Ch 270 at 286-287

[4] Ibid at 292

This will commonly come into play when it is a question whether the trustee of a trust whose objective is to confer financial benefits on beneficiaries has sufficiently pursued these financial interests.[5]"

The Australian Law Reform Commission, when recommending that legislation codify minimum trustee fiduciary duties, identified the "duty to act always in the best interests of the members of the scheme" as a minimum duty, and that this duty was focused on financial interests, or more specifically members' "economic wellbeing".[6]

1.1.1.3 Maximising net returns is consistent with system objectives and public policy

The Productivity Commission has previously stated: "Maximising net returns (after fees and taxes) is the most important way in which the superannuation system contributes to adequate and sustainable retirement incomes."[7]

The overarching objective of the superannuation system being to support the financial wellbeing of retirees not to meet the individual preferences of members. This policy position has continued since the introduction of Choice of Fund; the legislative history makes clear that competition was meant to improve returns and lower fees and costs, not to excuse poor financial performing funds and products by asserting that "members chose poor performance".

1.1.1.4 Other proposed factors are difficult to value directly, but if important would be reflected in long term net returns

Other benefits referenced by the draft APRA Prudential Standard SPS 225 and Prudential Practice Guide PPS 225, including service quality and governance, are difficult to value and could reasonably be expected to be reflected in long term net fund level performance.

1.2 Trustee quality is critical to member outcomes. The loyalty, diligence, and competence of trustees are reflected in fund level performance.

Trustees are responsible for initial and ongoing strategic asset allocation (which may be varied from time to time), manager selection, and the provision of a range of services (either directly or through third parties). For superannuation members, the future is uncertain and their outcomes are shaped in large part by trustee decisions before a member joins a product, and thereafter. Information asymmetry is significant in superannuation. It is difficult for members to monitor trustee decisions and product features on an ongoing basis. As a result, there is substantial scope for trustees to generate value for members, on the one hand, or extract value from members, on the other hand. The scope of trustee discretion is substantial, and long- term fund-level rates of net return can be informative in respect of the competence and diligence of a trustee across the fund's operations in respect of all members and products.

APRA's proposed standards are silent on the responsibility of the trustee for establishing fund-level strategies and the relevance of this responsibility to member outcomes. Establishing and monitoring the product mix, and the distribution model of a fund, and consequent member choice outcomes, is the responsibility of the trustee.

---

[5] Invensys Australian Superannuation Fund Pty Ltd v Austrac Investments Limited and Others [2006] VSC 112 at 107

[6] Report of the Australian Law Reform Commission and the Companies and Securities Advisory Committee, Collective Investments: Superannuation (1992), page 105 (citing Ford HAJ and Lee WA, Principles of Law of Trusts (2nd ed, The Law Book Co Ltd,1990), p 400.

[7] Productivity Commission, How to access the Competitiveness and Efficiency of the Superannuation System, November 2016 at 7

Fund-level long term net returns are the key indicator for assessing trustee quality.

The proposal's focus on product-level assessment is not defensible based on member choice because the trustee cannot subordinate its fund-level duties based on member choice. [8]

1.3 Application to MySuper products

As currently drafted, APRA's proposed Prudential Standard SPS 225 would not apply the same outcomes assessment framework to MySuper products and to Choice products. The current draft would permit MySuper products to meet with the proposed outcomes test by applying the scale test.[9] The proposal does not provide a rationale for this approach. We understand it may be a drafting error.

MySuper products should be required to undertake the same prudential assessment process as that required for other superannuation products. Compliance with the legislative requirements in Superannuation Industry (Supervision) Act section 29VN does not (and should not) preclude compliance with proposed Prudential Standard SPS 225.

2. Fund expenditure requirements

Proposed revisions to Prudential Standard 220 would require more extensive policies and procedures in respect of "fund expenditure," and would require a business case for every "significant" expenditure.

The proposed standard defines fund expenditure as "any cash outflow and expected future cash outflow from the assets of an RSE, including payments to and from reserves, not otherwise allocated to members' accounts.[10]"

Retail funds typically outsource all operations (other than custodian services) to related parties. As a result, there is a risk that most material expenditures by retail funds will not be subject to this standard and thus retail funds processes will be subject to less rigorous assessment by APRA than profit for member funds.

3. Reporting standards and APRA's future directions

Whilst the consultation package broadly outlines the objectives APRA intends to achieve with respect to reporting standards, there is not enough detail to provide substantive comments.

---

[8] APRA Superannuation Circular No. II.D.1 Managing Investments and Investment Choice (2006) (the Circular) states that "Trustees' responsibilities when making investment decisions include formulating and implementing an investment strategy or strategies. … When formulating an investment strategy the trustee is required to consider, at the entity level, the risk and likely return from investments, the diversification of those investments, liquidity requirements and the ability of the entity to discharge its liabilities. Where investment choice is offered, beneficiaries may choose between strategies that have been developed by trustees according to this framework. … The underlying policy intent is that the provision of member choice of investment strategy does not remove the need for the trustee to ensure that the investment strategy or strategies of the fund comply with the requirements set out in the legislation. Rather, s. 52 of the SIS Act should be read and complied with in its entirety. That is, trustees accepting member direction under s. 52(4) of the SIS Act are not relieved of their s. 52(2)(f) duties, most relevantly the duties to ensure a reasonably liquid and properly diversified fund."

[9] Draft Prudential Standard SPS225 footnote 4.

[10] Draft Prudential Standard SPS 220 paragraph 22

We note that many super funds currently report zero investment expenses,[11] notwithstanding that look through information collection powers exist.

We would encourage APRA to consider how that issue can be resolved. It was not clear from the discussion paper that the reporting of no investment expenses by some funds was a concern.

In relation to information collection in respect of other kinds of expenses, APRA should first ensure that the total expenses (other than investment) are actually being reported, and then identify what sub categories of expenditure are important to APRA's regulatory interests. The discussion paper was silent on what categories were being considered by APRA and the basis for seeking information on them. There are a number of potentially important categories that have been empirically shown to be relevant to member outcomes, such as payments to related parties, profits paid directly and indirectly from a superannuation business; there may be others worth considering. Additional consultation would be important.

4. Recommendations

4.1 Outcomes assessment

For the outcomes assessment proposals to have a reasonable chance of being successful, APRA should give consideration to the following suggested changes:

4.1.1 A fund-level assessment is necessary, and should be added to the outcomes assessment framework

As noted in section 1.2 above, trustee quality is critical to member outcomes, and reflected in long term fund- level net returns.

The fund-level assessment should mandate that the key indicator of whether a fund is likely to be delivering satisfactory member outcomes is demonstrated by: above-median long- term net returns at the fund level.

Funds that are delivering below median returns for every year in a rolling five- year period should be required to notify APRA. Funds that have 10- year average annual returns below the median fund should also be subject to this requirement.

Supplemental analyses that trustees should perform include:

- Benchmarking whole of fund net returns to asset class benchmarks based on the fund's actual asset allocations thereby identifying the efficiency of the fund in delivering net returns to members based on the exposure to underlying assets, and
- Determining not just whether there is sufficient scale at the fund level, but whether the benefits of scale flow through fully to beneficiaries by way of increased returns.

[11] Of these, nearly all are bank-owned and other retail funds (there are a small number of public sector funds, and no industry funds).

4.1.2 The option-level assessment contemplated in the proposal should identify key indicators and methodologies

The option-level assessment should mandate that the key indicator in determining whether member outcomes are likely to be satisfactory or unsatisfactory is demonstrated by: above-median long- term net returns at the relevant option level based on comparable options.

Comparability for diversified options would be determined by the allocation to growth assets of an option. For single asset class options, that is options with 80% or more of the assets invested in a single asset class (for example international shares, Australian shares, property, cash) comparability would be made against other funds options with investments of at least 80% in that asset, subject to there being at least a reasonable number of other options with that asset class characterisation. The proviso requiring a reasonable number of other options with that asset class characterisation would prevent a provider from claiming 'financial innovation' of a new and unique single asset class option against which no comparison could be made.

In this regard APRA may wish to consider using SuperRatings' standard categories for premixed and single-asset class strategies. For pre-mixed, the categories are (i) *Secure* (options in this category have between 0-19% growth assets); (ii) *Capital Stable* (options in this category have 20-40% growth assets); (iii) *Conservative Balanced* (options in this category have 41-59% growth assets); (iv) *Balanced* (options in this category have 60-76% growth assets); (vi) *Growth* (options in this category have 77-90% growth assets); and (vii) *High Growth* (options in this category have 91-100% growth assets). The categories of single asset class strategies are: (i) *Australian Shares*; (ii) *Cash*; (iii) *Diversified Fixed Interest*; (iv) *International Shares*; and (v) *Property*.

Additional analyses that should be performed by the trustee include:

(i) An analysis of whether products fees are appropriate for the asset allocation and investment approach adopted, noting that fees are not the same as net benefit to members and accordingly should be afforded a low weighting;

(iii) Costs per member in the option, noting that costs are not the same as net benefit to members and, as noted above should be afforded a low weighting;

(iv) The trustee should determine not just whether there is sufficient scale at the option level, but whether the benefits of scale flow through fully to beneficiaries by way of increased returns; and

(v) Benchmarking of product net returns to system averages or naïve portfolios to ensure they are sufficiently efficient to be a reasonable instrument of social policy consistent with system policy objectives.

APRA should require that a trustee's member outcomes assessment focuses squarely on fund level net returns rather than permitting a trustee to adopt extensive assessment criteria. By requiring a trustee to make its assessment on this basis would inevitably result in other aspects of its product design being positive for members.

4.1.3 MySuper

MySuper products should be subject to the same prudential assessment framework as other superannuation products.

4.1.4 Member segmentation should be limited if permitted at all

The proposed prudential standard and guidance is focused on option-level assessment, but appears to permit the assessment to vary for different members. It is not clear why this is appropriate.

Superannuation funds are similar in many respects to collective investment schemes. The members are entitled to horizontal equity.

As a collective scheme, superannuation trustee duties involve acting in the best interests of the members' in terms of maximising financial wellbeing of each member through the collective endeavours, not providing personal advice and asset management. A segmented or tailored approach to member outcome assessment risks blurring the trustee's broad duties to all members with an individually tailored approach to achieving the personal outcomes sought by a member.

The key indicator of net returns to members should not segment between accumulation and retirement phase members because all members have the common and universal need to maximise retirement benefits.

To date, there is no clear public policy architecture setting out the system imperatives in respect of retirees and retirement income separate from system objectives. It is expected that superannuation policy in relation to retirement income will form over time. Accordingly, APRA prudential standards and guidance should not set in stone segmentation differences between retirement phase and accumulation members.[12]

4.2 Fund expenditure requirements

Prudential Standard 220 should be amended to ensure that "expenditures" subject to the standard include expenditures by related parties under common control of the trustee on behalf of the trustee.

[12] It is possible that, as the superannuation system matures, there will not be separate default products for accumulation and retirement (the fact that there is a distinction now is due entirely to path dependency). The default product may reflect a mature system objective, in which case trustee endeavours in respect of all members or at least default members will have a single objective, namely the delivery of regular retirement income that is as high as possible, is resilient to market volatility and lasts for a lifetime.

Melbourne
Casselden Place
Level 39, 2 Lonsdale St,
Melbourne, VIC 3000
P: (03) 9657 4321

Canberra
GF Dialogue
4 National Circuit
Canberra ACT 2600
P: (02) 6273 4333